DEREGULATION OF FINANCIAL INSTITUTIONS AND ITS IMPACT ON SMALL BUSINESS FINANCING

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

WASHINGTON, D.C., OCTOBER 19, 1983

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
28-402 O
WASHINGTON : 1983

A721-9

COMMITTEE ON SMALL BUSINESS

PARREN J. MITCHELL, Maryland, *Chairman*

NEAL SMITH, Iowa
JOSEPH P. ADDABBO, New York
HENRY B. GONZALEZ, Texas
JOHN J. LaFALCE, New York
BERKLEY BEDELL, Iowa
HENRY J. NOWAK, New York
THOMAS A. LUKEN, Ohio
ANDY IRELAND, Florida
IKE SKELTON, Missouri
CHARLES W. STENHOLM, Texas
ROMANO L. MAZZOLI, Kentucky
NICHOLAS MAVROULES, Massachusetts
CHARLES HATCHER, Georgia
RON WYDEN, Oregon
DENNIS E. ECKART, Ohio
GUS SAVAGE, Illinois
BUDDY ROEMER, Louisiana
NORMAN SISISKY, Virginia
FRANK McCLOSKEY, Indiana
ESTEBAN EDWARD TORRES, California
TOM J. VANDERGRIFF, Texas
JIM COOPER, Tennessee
JAMES R. "JIM" OLIN, Virginia
C. ROBIN BRITT, North Carolina
RICHARD RAY, Georgia

JOSEPH M. McDADE, Pennsylvania
SILVIO O. CONTE, Massachusetts
WILLIAM S. BROOMFIELD, Michigan
LYLE WILLIAMS, Ohio
JOHN HILER, Indiana
VIN WEBER, Minnesota
HAL DAUB, Nebraska
CHRISTOPHER H. SMITH, New Jersey
DAVID DREIER, California
GUY V. MOLINARI, New York
TOBY ROTH, Wisconsin
GENE CHAPPIE, California
SHERWOOD L. BOEHLERT, New York
MICHAEL BILIRAKIS, Florida
DAN SCHAEFER, Colorado

MAJOR L. CLARK III, *Staff Director*
THOMAS G. POWERS, *General Counsel*
LOIS LIBERTY, *Publications Specialist*
RAYMOND S. WITTIG, *Minority Counsel*

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

HENRY J. NOWAK, New York, *Chairman*

BUDDY ROEMER, Louisiana
TOM J. VANDERGRIFF, Texas
C. ROBIN BRITT, North Carolina
DENNIS E. ECKART, Ohio
JAMES R. "JIM" OLIN, Virginia

LYLE WILLIAMS, Ohio
CHRISTOPHER H. SMITH, New Jersey
DAVID DREIER, California

BENSON S. GOLDSTEIN, *Subcommittee Counsel*
JOHN T. CAULFIELD, *Subcommittee Associate Counsel*
JOHN L. DALTON, *Minority Subcommittee Professional Staff Member*

CONTENTS

Page

Hearing held on October 19, 1983 1

Nowak, Hon. Henry J., chairman, Subcommittee on Tax, Access to Equity Capital and Business Opportunities: Opening statement 1

Testimony of:

- Dennis, William J., Jr., director of research, National Federation of Independent Business 14
- Glover, Howard T., president, Conneaut Savings and Loan Co 247
- Lauffer, James R., president, First National Bank of Herminie, Pa., on behalf of the Independent Bankers Association of America, and the Small Business Legislative Council 122
- Mooney, William M., senior vice president, Chemical Bank of New York; accompanied by William H. Wulfing, vice president and director of small business, small business unit 134
- Swain, Frank S., Chief Counsel for Advocacy, Small Business Administration 2

Additional material supplied for the hearing record:

- Dennis, William J., Jr., director of research, National Federation of Independent Business:
  - Article, "Rate Woes in Farm Belt" 115
  - Prepared statement with attachments 17
- Glover, Howard T., president, Conneaut Savings and Loan Co.: Prepared statement with attachments 243
- Lauffer, James R., president, First National Bank of Herminie, Pa., on behalf of the Independent Bankers Association of America, and the Small Business Legislative Council: Prepared statement with attachment 127
- Mooney, William M., senior vice president, Chemical Bank of New York; and William H. Wulfing, vice president and director of small business, small business unit: Joint prepared statement with attachments 139
- Swain, Frank S., Chief Counsel for Advocacy, Small Business Administration: Prepared statement 6

APPENDIX

National Small Business Administration: Prepared statement 295

Macklin, Gordon S., on behalf of the National Association of Securities Dealers, Inc.: Prepared statement with attachment 297

DEREGULATION OF FINANCIAL INSTITUTIONS AND ITS IMPACT ON SMALL BUSINESS FINANCING

WEDNESDAY, OCTOBER 19, 1983

House of Representatives,
Subcommittee on Tax, Access to Equity
Capital and Business Opportunities,
Committee on Small Business,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2359, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. Nowak. The subcommittee will come to order. We'll have a brief opening statement, and then we'll get right into our witnesses, whom I want at the outset to thank for their cooperation with the subcommittee in the preparation of this hearing and certainly for your presence here today.

Today we begin an investigatory hearing concerning the deregulation of financial institutions and its impact on small business financing.

Our Nation has been undergoing a major financial structural change with the rise of so-called financial supermarkets and the evolving deregulation of the Nation's banking industry. The goal of deregulation is to open competition in the financial services industry while at the same time maintaining the soundness and the integrity of our country's financial institution. As these trends develop, it is essential that those of us concerned with small business closely monitor these changes, concentrating on achieving a balanced plan of financial deregulation which insures adequate and affordable capital to our small business community.

The effect of any deregulation scenario is important to small business capital formation for a variety of reasons. Specifically, small business has been traditionally denied access to commercial paper and bond markets, and has consistently relied on commercial bank credit as a primary source of credit. In fact, a survey of bankers by the Interagency Task Force on Small Business Finance indicates that small firms obtain approximately 70 percent of their credit from commercial banks. In addition, with small firms paying 2 to 3 percentage points above the prime rate, the relaxation of the interest rate restriction may have severely limited the affordability of capital to small firms.

A further concern expressed by many in the small business community is that total geographical deregulation may bring about the elimination of small community-based banks which have historically served the credit needs of local small businesses. Opponents of the proposals to eliminate interstate banking restrictions have argued that the implementation of this measure would result in a limited number of large centralized banks which may find it economically infeasible to lend to small firms or may be unable to understand the financial situation of a particular small business.

Last year this subcommittee held hearings on this issue to investigate the early deregulation proposals and their potential impact on small business financing. One of the salient recommendations from that hearing was the need to develop an improved data base regarding small business lending practices. Subsequently, there have been several studies and surveys concerning this area, which should enable us to formulate a broader perspective of the present and prospective effects of deregulation on small business. This improved source of detailed information should provide a greater understanding of the problems and/or the benefits of deregulation as they relate to small business and afford those intimately involved with the small business community to effectuate policy which will guarantee an adequate flow of needed capital to small firms at affordable prices.

With these brief thoughts in mind I would like to welcome our first witness, Mr. Frank Swain, who is the chief counsel for advocacy at SBA. Mr. Swain has appeared several times before the subcommittee, and is well versed in the many important issues facing the small business community. Your statement will be incorporated in the record in total, and you may proceed as you so desire.

TESTIMONY OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you very much, Mr. Chairman. I am pleased to be here, and I must congratulate you and the members of the committee for your continued interest in this area.

The changes presently occurring in the financial community are of tremendous importance to small business. Clearly, the one thing that we consistently hear from small business is that they have greater sources, they need increased access to capital, both equity capital and debt capital. Clearly a lot of what is going on now has a tremendous impact on that need. It is sometimes occurring so fast that we can't keep track of it, and so I congratulate you and the subcommittee for continuing to attempt to look at the implications of bank and other financial changes on small business.

In May 1982 when I appeared before your subcommittee on this issue, I presented three important small business concerns.

The first concern was the impact on smaller financial institutions, of increased competition among financial institutions as mergers and acquisitions continue, as institutions broaden their base of operations, and as State and Federal policies change.

The second concern was for the development of an organized regulatory environment for the financial services industry, and equitable regulations for all segments of that industry.

For each segment of the industry I suggested that consideration should be given to size so that regulatory costs would not be unduly burdensome for our smaller financial institutions.

Our third concern related to the first two. I felt that steps must be taken to document the impact on small business of the structural, regulatory, and legislative changes occurring within the financial services industry as the initial basis for future action.

As you mentioned in your opening statement, this lack of data and hard research in this area has been clear and particularly frustrating for small business policymakers, and I'd like to review very briefly, Mr. Chairman, some efforts that our office has made in that area. As part of our continuing research program we developed additional data which reflect the significance of smaller banks to local financing of small firms.

I believe the committee has been provided with a draft copy of a study prepared by Profs. James W. Kolari and Donald R. Fraser of Texas A&M University, in which they attempted to look at the continued health of small banks and large banks. The data looked at involved financial ratios and other financial formulas for small banks from 1964 to 1981 with particular emphasis on differences in financial ratios among the banks of different sizes. This study has been extended to include 1982 data. Results of the 1982 review are expected shortly.

Prior to this time there was no comprehensive evaluation of financial behavior of small banks over a long period of time. The study sampled 1,000 banks from Federal data, stratified in several different size breaks. We think the study was much more extensive both in terms of time and sample size than any previous look at the behavior of small banks, and the findings are briefly these:

Small banks, that is to say banks with fewer than $25 million in assets, consistently earned higher returns on assets compared to the other larger banking groups.

Peak earnings among the smallest banks coincide remarkably well with the movement of interest rates, which is also another way of saying that the small bank earnings were somewhat more volatile than larger bank earnings.

Now there is little evidence to suggest, at least historically, that small banks are unable to compete with larger banks within the interest rate environment observed over the sample period; however, I must say that the sample period in 1964 through 1981 was quite a different interest rate environment than we have now with the deregulation of interest rates since 1982.

The return on net worth for small banks appears to exceed such a return for other sized banks during high interest rate periods. Small banks have historically had substantial more equity as a percentage of assets than the other two groups, and the ratio of gross loans to deposits for small banks exceeded the ratios for largest banks between 1975 and 1980, suggesting that small banks became more aggressive in extending commercial and industrial loans as well as consumer loans during this period.

Several other findings, Mr. Chairman, which are outlined in my statement as well, of course, as in the study itself. What the study really does is provide a baseline, saying that traditionally, as you mentioned in your statement, small banks have been an important source of capital for small business, and if we are concerned about the health of small banks we can see that small banks have done reasonably well under the financial regulatory environment that existed at least from 1964 through 1981.

We have asked the researchers to extend their work through 1982, and provided them with the Federal Deposit Insurance Corporation data in order to do that, because I think the period 1981 through 1982 is the beginning of some extremely stressful times for smaller banks both because of the economy and because of the changes in interest rates.

I am not sure what that study tells us on how to predict what's going to happen in 1982 and thereafter. It certainly tells us that small banks have been viable, important, and had an opportunity to earn a good return for themselves and serve the small business community.

I think that as we proceed into a changed financial environment, if we can take a look at the behavior of small banks compared to that very extensive baseline period, 1964 through 1981, that will provide us with some important keys as to what the implications of the current economic and regulatory situations are for overall small bank performance.

The bottom line for small banks is only one look at the issue. We have had some research on another interesting aspect, and that is why people decide to make loans to small business or not small business, and the research report done by Albert Shapero of Ohio State University provided us with a couple of interesting findings. His research suggested that first of all there are very marked differences by community, bank and individual loan officers to a given loan request.

Second, whether a banker makes a loan to a particular firm may be associated with the age, educational background, work experience and measured preference for risk of that particular loan officer, and not necessarily the size or structure of the bank.

Finally, the amount and kinds of assistance and relevant advice a bank provides to a new or young company are associated with how the banker perceives his or her roles, whether it's assisting new or young firms or providing for low defaults and a careful lending record by the bank, which is a long-winded way of saying that regardless of the structure, whether we have a lot of large banks or a lot of small banks or a good mix as we do now, the attitude of a particular lending officer may be positive or negative for small business, whether or not they're with a large bank, or with a small bank.

There's a certain attitude problem or an attitude challenge, say, on whether small firms are good lending clients regardless of bank size.

The committee has also received a copy of a statement that we submitted to Vice President Bush's task force on the regulation of financial services back in April. Obviously, that task force has continued their debates, and the committee has a summary of our statement there. I would like to mention just a couple of the points that we made to the task force.

We have a very major concern that capital asset regulations should be uniform in size. Right now the Federal Reserve Board requires different sized banks to have different capital ratios.

Also, small firms are stymied by State securities laws, even though they're allowed to be exempt under the Federal SEC rules, and we have encouraged the State securities commissioners to bring some uniformity to that, and to balance out their need to protect the investor with a need to encourage a flow of venture capital and new business starts in their particular States. We think that an active trading market in securities of smaller companies need to be developed, and the SEC, the SBA, and others with small business interests should assist in structuring a modern secondary market system to increase the investment liquidity for smaller firms.

We think that uniform data collection procedures should be instituted to measure for the cost to all sizes of financial institutions of regulatory compliance to determine which regulations are particularly burdensome and to enhance the monitoring of capital and credit flow by size of business.

I would also like to mention to the committee that within the last 2 weeks the Office of Advocacy has signed a contract for the University of Michigan to do a pilot study of the flow of capital to small business.

We don't know who makes loans to small business really. The best work has been done recently. You alluded to it in your opening statement, the 1981 report by the Interagency Task Force, but really nobody has been able to take a hard look at where small firms are getting their money, and what types of financial institutions they're getting them from. We hope that this pilot work with with the assistance of the University of Michigan may provide us with some very necessary data in the area of flow of capital and credit to small firms so that we can present it to you, and other Members of Congress who are interested in making policy decisions on financial regulation questions.

My purpose here this morning is not to advocate any specific legislative proposals. We await the recommendations of the Vice President's task force report, and they should provide a comprehensive agenda for legislative debate and action.

The question which remains unanswered, however, is whether the changing financial services environment will change the perceptions and attitudes of local financial officers. Congress cannot legislate lending officers into the pursuit of small business clients.

Mr. Chairman, access to credit is crucial to small business health, and we have found that smaller financial institutions do a better job of providing that credit to the small business community.

Changes are occurring rapidly in the financial services industry, and those who service small business must adapt rapidly to survive in a more competitive market. That is not necessarily bad.

I think that small businesses and the financial community that serves them should welcome increased opportunities that come with less regulation. At the same time we ought to insist that the process of deregulation and the regulations that remain do not stand in the way of new and existing smaller financial service businesses nor hinder their ability to continue to provide credit to smaller firms at affordable rates.

I believe small business borrowers will be well-served by a more competitive environment. This is the source of my previously stated concern for specific equitable bank capital regulations, even-handed antitrust policies, and an ultimate regulatory structure for the financial services industry that provides a realistic competitive environment for small financial institutions and their small firm clients. I do not think we can stop the clock nor that we should, but I welcome your attention to this issue, and believe that Congress will benefit from the focus you are providing to the small business aspects of this issue.

Thank you, Mr. Chairman. I will be happy to try to respond to any questions.

[Mr. Swain's prepared statement follows:]

PREPARED STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. Chairman, I would like to thank you for the opportunity to participate in the very important continuing debate on the deregulation of our Nation's financial institutions.

In May 1982 when I first appeared before your subcommittee on this issue, I presented three important small business concerns.

The first concern was the impact on smaller financial institutions, of increased competition among financial institutions as mergers and acquisitions continue, as institutions broaden their base of operations, and as State and Federal policies change.

The second concern was for the development of an organized regulatory environment for the financial services industry and equitable regulations for all segments of that industry. For each segment of the industry, I suggested that consideration should be given to size so that regulatory costs would not be unduly burdensome for our smaller financial institutions.

The third concern related to the first two. I felt that steps must be taken to document the impact on small business of the structural, regulatory and legislative changes occurring within the financial services industry as the initial basis for future action. The lack of data and hard research in this area has been clear and particularly frustrating for small business policymakers. Since May of 1982, we have funded several research efforts in the financial services area and I would like to share some of the findings with you this morning.

ADVOCACY RESEARCH—1983

As part of Advocacy's continuing research program on behalf of small firms and smaller banks, we have developed additional data which reflect the significance of smaller banks to local financing of small firms.

A study performed by James W. Kolari and Donald R. Fraser of Texas A & M University has provided some empirical evidence regarding the financial condition of small banks from 1964–81, with particular emphasis on differences in financial ratios among banks of different sizes. This study has been extended to include 1982 data. The results of the 1982 review are expected shortly.

Studies prior to this one had not comprehensively evaluated the financial behavior of small banks over a long period of time, had not measured bank financial conditions contrasting small vs. large banks and had not set out specific information on the majority of banks with assets of less than $25 million (small banks for purposes of this report).

When the 1,003 sampled banks were stratified by (1) less than $25 million in assets (small banks), (2) $25–$100 million in assets (intermediate banks), and (3) more than $100 million in assets (large banks), the following observations were made. For the period 1964–81:

Small banks (less than $25 million in assets) consistently earned higher returns on assets compared to the other two groups.

Peak earnings among the smallest banks coincide remarkably well with the movement of interest rates.

There is little evidence to suggest the inability of small banks to compete with larger banks, at least within the interest rate environment observed over the sample period.

The return on net worth for small banks appears to exceed such return for other sized banks during high interest rate periods.

Small banks have historically had substantially more equity as a percentage of assets than the other two groups.

The ratio of gross loans to deposit for small banks exceeded the ratios for largest banks between 1975-80 suggesting that they became more aggressive in extending commercial and industrial loans as well as consumer loans during this period.

Larger banks are more prone to reduced earnings rates in periods of either rising or volatile interest rates than smaller banks. In this regard the ability of smaller banks to realign asset portfolio toward more liquid assets appears to have a positive effect on the stability of small bank earnings.

Small banks, which are otherwise unable to obtain debt capital in the financial marketplace, maintain growth rates comparable to larger banks by means of greater equity participation. The added equity is provided by lower dividend payment ratios than larger banks.

Since 1970 the intermediate group of banks had lower operating expenses per unit of income than banks in the smaller and larger groups.

Increased pressure on small banks to innovate through development of electronic facilities could adversely affect their operating efficiency more than medium or larger-sized banks.

The analysis of financial performance of small banks during the 1964-81 period provides no evidence that small banks will be unable to compete in coming years. Rather, the researchers indicate that the financial performance of small banks in past years has been comparable to larger banks, often better.

The Texas A & M study also provides a basis of forecasting bank failures using individual financial ratios. Specifically developed models were applied to a sample of 79 failed banks during the years 1970-80 and to 1,003 survivor banks used in the analyses described above. This analysis did not produce any evidence that small banks are more risky than large banks, nor that the failure probabilities of small banks have increased over time. The Texas A & M researchers suggest that small banks taken as a group are neither more nor less prone to failure than large banks. Further they state that this finding is especially relevant for policy issues concerning capital adequacy and other regulatory issues pertaining to small banks.

This research has provided some first time approaches and analyses in a very complex and volatile area. Some of the findings represent an important initial step in gathering data for determining the impact of financial deregulation on small firms in the financial services industry.

Advocacy research has also produced an interesting report from Albert Shapero of Ohio State University dealing with the role of financial institutions in local communities in the context of innovative small firms. Data were collected from a survey of financial decisionmakers in two distinct communities, Columbus, Ohio and Louisville, Ky. Ten different investment situations in young innovative firms were presented to the surveyed group to determine their attitudes and propensity to invest. His research suggests the following:

(1) There are very marked differences by community, bank and individual loan officers in their responses to a given loan request.

(2) Whether a banker makes a loan is associated with age, educational background, work experience and measured preference for risk.

(3) The amount and kinds of assistance and relevant advice a banker provides to a new or young company are associated with how the banker perceives his or her role (assisting new or young firms or providing for low defaults and delinquencies).

The report cites a key role for local banks in helping to support the formation, survival and growth of desirable new and young ventures in a community.

TASK GROUP ON REGULATION OF FINANCIAL SERVICES

As you are aware, Vice President Bush has headed a task group on the subject of the changing financial services industry. This task force solicited comment on a broad range of issues and in April we submitted extensive comments which I have provided separately to the subcommittee staff. Some of my recommendations were as follows:

Capital regulations should be uniform for regulated depository institutions of all sizes without causing undue burden on smaller depositories. Capital regulators should not arbitrarily categorize large banks as less risky than small banks.

The existing deposit insurance arrangement should be reconsidered. Options available for revising the deposit insurance system to encourage risk-related insurance premiums and less dependence on Federal support include: (a) the deposit insurance system could be structured in a self-funded, self-regulatory framework; (b) variable-rate premiums could be instituted based on riskiness of the institution's portfolios and other rating criteria; and (c) private insurance or public/private coinsurance could be given serious consideration.

Federal and State regulators must improve their efforts to coordinate securities and banking law regulations to permit an active, competitive environment for new and existing small/medium-size financial entities.

An agenda should be established to resolve financial regulatory inconsistencies which have led to differential treatment of similar activities of financial institutions.

The minimum exemptions from reporting and disclosure requirements under the securities laws should be increased from the levels of $3 million in assets and more than 500 shareholders to at least $10 million in assets/revenues.

An active trading market in the securities of smaller companies needs to be developed. The Securities and Exchange Commission [SEC], the SBA, and others with small business interests should assist in structuring a modern, secondary market system to increase the investment liquidity and efficiency for smaller company securities. Such an improvement could contribute to a reduction in the cost of capital for these firms, improve investor interest and establish a firm's current net worth.

Changes in securities regulations must reflect the potential impact of such changes on small and regional securities firms. Small/medium-size companies depend on these securities firms for initial and continuing efforts to raise growth capital in the public capital markets.

Uniform data collection procedures should be instituted to measure for the cost to all sizes of financial institutions of regulatory compliance to determine which regulations are particularly burdensome and to enhance the monitoring of capital and credit flows by size of business. Until this is done, small business credit and capital flows cannot be adequately measured, nor can the effect of public policy be more accurately determined.

Some of Advocacy's future research efforts will address some of these specific issues.

My purpose here is not to advocate any specific legislative proposals. The Vice President's task force report and recommendations should provide a comprehensive agenda for legislative action. The question which remains unanswered, however, is whether the changing financial services environment will change the perceptions and attitudes of local financial officers in a positive or negative way toward small firm financing. Congress cannot legislate lending officers into the pursuit of small business clients.

CONCLUSION

Mr. Chairman, access to credit is crucial to small business health and we have found that smaller financial institutions do a better job of providing that credit to the small business community. Changes are occurring rapidly in the financial services industry and those who serve small businesses must adapt rapidly to survive in more competitive markets. I think that small businesses and the financial community that serves them should welcome increased opportunities that come with less regulation. At the same time, we ought to insist that the process of deregulation and the regulations that remain do not stand in the way of new and existing smaller financial service businesses, nor hinder their ability to continue to provide credit to smaller firms at affordable rates. I believe small business borrowers will be well served by a more competitive environment; this is the source of my previously stated concerns for specific equitable bank capital regulations, evenhanded antitrust policies, and an ultimate regulatory structure for the financial services industry that provides a realistic competitive environment for small financial institutions and their small firm clients. I do not think we can stop the clock, nor that we should. I welcome your attention to this issue and believe that Congress will benefit from the focus you are providing to the small business aspects of the issue.

Mr. **Nowak**. Thank you very much, Mr. Swain. Let me get into a couple of areas that you've touched on, but before I do that, the information that we have been provided is that in the 2½ years of deregulation through 1983, the number of savings and loan associations have declined by more than 20 percent from approximately 4,600 units to 3,650 institutions.

I wonder if there's a concern both from the point of competitiveness as to the ability of those areas where those banks have gone out to be served by adequate financial capital.

Mr. **Swain**. Well, of course, the savings and loan industry has traditionally, by regulation, been oriented to the home building market. I am not aware of any studies which have attempted to assign the blame for the very difficult times that S&L's have had in the last year and what part of it was due to the significant interest rate pressures that were there before the interest rate cap was lifted or what part of it was due to financial deregulation.

I think that we have heard no complaints about the law that was passed last year which allows S&L's to get involved in a greater way in commercial lending, and, in fact, I believe that the SBA, for instance, is working with several savings and loan groups to get them more involved in working through SBA guaranteed loans.

Obviously, whenever you have a point of credit access in a local community that was at one point there, and is no longer there, that's cause for concern, but I am not sure without looking at it a little bit closer whether the S&L's actually went out of business, how many of those actually went out of business and closed their doors, period, or how many were assumed by other institutions in the area, and may still be open, albeit under a different management.

You and I are both from upstate New York, and my hometown of Corning, when I was growing up, I think that there were three or four locally owned banks right in that community, and the Lincoln First Bank, which as you know, is a major upstate holding company.

I do believe that there are the same number of banks there today, the same number of doors that are open, although they're all owned by Buffalo and Rochester based banks.

I don't know whether the local community regards that as good or bad. I think it's good that there are still as many choices to go to, but whether the management or the lending practices have changed because the people come down from Buffalo or whether they come from Corning is another question.

Mr. **Nowak**. The committee had a hearing a few weeks ago concerning secondary markets for SBA and guaranteed loans, and I am wondering if your office has thought about some type of tie between the secondary markets and the process of banking deregulation to provide a more viable turnover rate for small commercials as a lend-out both through the SBA guaranteed loan program and the direct lending program. We are also trying to generate some interest in looking at the GNMA type of guarantee to formulate some type of secondary market sales avenue to expand their abilities.

Mr. **Swain**. I think that I agree very much with the interest of SBA Administrator Sanders and the interest of you and your committee as well in expanding the potential for the SBA secondary market.

It's a very complicated area, and I don't pretend to understand all of its details, but to my mind the whole reason to expand the

SBA secondary market is to make it more viable for a bank to use the SBA guarantee, and if more banks use the SBA guarantee, then there will be more sources, more windows open for application for SBA guarantee.

One of our problems is that of the 15,000 or so banks of the United States, I believe that there are about 1,500 who regularly use the SBA guarantee. That's a very interesting question you pose, Mr. Chairman, as to whether some of the current deregulatory or change regulatory environments will have an impact on the secondary market.

I don't know the answer, but let me try to give some thought to it, and put some people to work on it, and get back to you on it. I think, to my mind, it presents a potential for maybe getting some banks that have not traditionally been interested in working with the SBA, now involved with the SBA.

The secondary market has worked very well and GNMA and in other situations, and we would hope that as we attempt to increase the influence of the private sector in small business lending through the guaranteed route, we've got to provide a better way of having that capital flow around the private sector through the secondary market.

Mr. **Nowak**. But we will certainly hold the record open and also get into that question with some of our other witnesses. I think it is one that could be developed even with smaller numbers of financial institutions out there. If this were instituted totally, you'd probably get a large expansion of the credit availability for those small borrowers. If that could be packaged and sent on to the secondary market that exists today, you wouldn't have to be dealing with large numbers of institutions either.

Mr. **Swain**. We have had a tremendous problem, as you well know, at the SBA in terms of a fairly static number of personnel and increased responsibilities, and we've got to get out of the individual servicing and collecting and making of loans.

It is just that we don't have enough people to continue to do it and serve the small business community. The key to do that is to get the private sector responsibly involved. We think the secondary market is an excellent way of encouraging that.

Mr. **Nowak**. Thank you very much. We have Lyle Williams, ranking minority member from Ohio, and I am sure you've heard of his desire to do everything possible in this area to provide stability as well as growth for our small business community. I want to acknowledge at this time the fine cooperation we have had working in a bipartisan way. Welcome once again, Mr. Williams.

Mr. **Williams**. Thank you, Mr. Chairman. In your testimony you spoke of the need to have uniform data collection in order to monitor capital and credit flows, and I think most of us agree that we need that.

Have you any indication as to whether or not deregulation has increased or decreased the moneys available to small businesses?

Mr. **Swain**. That's really the $64 question, Mr. Congressman, and I am not going to make myself rich or anybody else that talks to me by being able to answer it any more accurately than anyone else. We do not know the answer to that question.

Theory would tell us, and I think it's well founded that if you have a deregulated environment more banks will be able to offer more services to everybody including small firms. You may well have more points of access for money from smaller firms.

Theory also, I think, would tell us that any business owner is going to do the most work where he or she can get the largest return on capital, so I think we need to—we have taken a look to the extent that there are potentially more avenues of capital for small business, but I think we need to do some more looking on how the market makes—be segmented, how, if we get more banks chasing large volume loans where the return is large, whether that means that there will be fewer banks serving small businesses.

I don't know whether that's the case or not, but that is what we're trying to—that's really the——

Mr. **Williams**. There's no indication one way or the other.

Mr. **Swain**. There's no indication one way or the other. I believe some of your other witnesses this morning are going to talk about some of the phenomena that we've seen as the economy has sort of straightened itself around and gone back to a more normal way of doing things. We've seen a reemergence of a spread on interest rates between——

Mr. **Williams**. You agree with that? Do you think the loan guarantee program does play a major role in helping us overcome some attitude problems?

Mr. **Swain**. Very definitely. The theory of the SBA loan program is that a banker who is looking at a potential client and that client doesn't have an adequate business record or adequate personal balance sheet for that banker to make a commitment on his own, will do so if backed by a partial guarantee from the SBA.

That SBA guarantee is clearly not to be that person's line of credit forever. It is to get that person a start in business or a start in expansion. Presumably the business will be successful and go on to be a profitmaking business and make money for the community and make money for the bankers.

The banker continues to lend to it. I have talked with a lot of bankers who say we use the SBA loan program although we think we lose money on it because it takes us more time to service the loan and set it up front, working with a client that may not have previous experience. However, after we get them off the ground, and they get some capital flowing, and they start to exercise their talents as a business owner, then we can start to make money from them, and I think the SBA guarantee provides in many cases that first step, the bridge between the entrepreneur and the banker, and after that successful experience the banker and the entrepreneur will go on to have a successful banking relationship without the involvement of the Government.

Mr. **Williams**. Thank you. Again, Mr. Chairman, thank you for your concern.

Mr. **Nowak**. Thank you. Tom Vandergriff from Texas.

Mr. **Vandergriff**. Thank you, Mr. Chairman.

All right, the Texas A&M study, did it relate strictly to Texas banks? Are you familiar with it?

Mr. **Swain**. Yes. I have it here, and I have supplied a copy of it to the committee. No, it did not relate specifically to Texas banks.

It was a study of a sample of all banks where information on those banks is collected by the Federal Deposit Insurance Corporation. The study happened to be done by professors at Texas A&M but it was a sample of nationwide data.

Mr. VANDERGRIFF. I see.

Mr. SWAIN. They did attempt to specifically study, in fact, New England banks, and the behavior of New England banks before and after NOW accounts were started back 3 years ago—that is still an ongoing part of the study. It clearly studied banks beyond the borders of Texas.

Mr. VANDERGRIFF. I appreciate that information. I would like to see a copy of the study, and you say you've made that available to the committee?

Mr. SWAIN. Yes, and we will provide your office a copy of it today, sir.

Mr. VANDERGRIFF. All right. I wonder if you could make a comment on a matter that is somewhat troubling to me. In my State, at least, there is a recent phenomenon of the larger holding companies heretofore concentrating on the ownership of banks in the major cities, purchasing banks in the smaller communities, in some cases in the very small communities. I have had reports that at least in the opinion of some small business owners, those banks are suddenly much more impersonal in their relationship with the small business community.

Is this a matter that has prompted your study in the past? Do you have any thoughts on it? Is there any kind of consistency in terms of a reaction that you've noted?

Mr. SWAIN. Let me make two comments in response to that question, Congressman. I believe that what you have heard about in Texas is probably, to some degree, a growing nationwide phenomenon.

The figures on mergers of banks and financial institutions have increased markedly in the last 2 years, and my gut reaction is that that is something that we have to be very watchful of. I don't know enough to say that it is necessarily a bad thing.

We have heard several instances where large banks have taken over what have traditionally been small community-oriented, locally owned retain banks, and there have been complaints that the procedures or the behavior of the bank officials has changed.

We don't know enough whether to say whether the lending to local business patterns has changed at all, and I will say this from the standpoint of somebody who has worked for small business a long time, small business people, I think, in their lending relations, have traditionally been oriented to just one banker, and a constant refrain that I make to small business people is that in order to be a good business person you are going to have to shop around for a bank and for lending terms just like you shop around for any other commodity that you might need to purchase for your business.

This is something that is very difficult for some small business people to accept, so on the one hand I am suspicious or I am very interested in taking a look at whether the increasing concentration of large banks and what have traditionally been small bank environments, means anything or not, and I think that bears very close watching.

We don't have any information on that other than the anecdotal type of information that you've just referred to.

On the other hand I do think the small business community has to realize that we cannot turn the clock back. It's not a good business practice just to go down and take whatever terms the corner bank offers to you whether it is the corner bank that you've been dealing with for 40 years or whether it's the corner bank repurchased by the bank in the larger city. We have to be, as small business people, very educated consumers of banking services because there's a lot more available out there now.

Mr. VANDERGRIFF. Well, I remember one line in your testimony, something to the effect that we can't legislate loan officers. I would quite agree with that, and we're certainly not going to reverse the trend of the acquisition of small banks by the major holding companies.

That's going to continue to take place. The only reason it concerns me and why I brought it up is that we may need to do some missionary work with the major banking and holding companies. I would imagine their philosophy is such that they want to be good citizens in each and every one of their respective communities, and perhaps working together we can develop a happier climate in those communities suddenly coping with a big city banker within their midst.

One other quick question, and it really doesn't bear on your testimony today, but I am just harking back to it because of events during these brief months that I have been here in Congress.

I am interested in all banks making money because they will loan more money if they make it, and I recall the massive mailing effort when we were considering the repeal of the tax on savings, dividends.

Mr. SWAIN. Yes, sir.

Mr. VANDERGRIFF. You recall?

Mr. SWAIN. I certainly do. I got a few pieces of mail myself.

Mr. VANDERGRIFF. In my experience, and I happen to represent some cities that are very large, but also many, many small communities, and in the smaller communities it was amazing, the percentage of people who actually were writing us. It appeared that the local banks in those communities had been much more influential on their depositors to write us than in the case of the large banks. Is that because of expenses being so much greater, and perhaps their having a greater concern about that imposed tax?

Mr. SWAIN. I think so. I think regardless of the philosophy whether you thought there should or should not be a tax, or whether the customers of the bank thought there should or should not be a tax, from a purely operational standpoint smaller banks would have had a more difficult time. Obviously a large bank is likely to have much more sophisticated computer and bookkeeping resources to make such a change that would be required by withholding system.

The changes would be much easier for a large bank to make than a small bank where the technology may not be quite as up-todate I would expect that the representatives of the small bankers said that they had a lot more to lose on that. It is actually a continuing issue on deregulation not only in the interest withholding issue, but also in general, the level to which technology is going to drive some of these changes. I think whether it's interest rate withholding or whether it is allowing banks to have automatic teller machines in the local grocery stores or whatever, we're going to continue to hear that that is a very good thing from the large banks that have obviously the financial resources to make whatever business decisions they can make because they'll always be able to install as many teller machines as they want.

For a small bank, although that sort of electronic flexibility is theoretically available to them, it may not practically be as available as to the large bank because the small bank doesn't have as many resources.

One problem is the statistics. There are a lot of asterisks and caveats, and that's one of the reasons that we're going to work with the University of Michigan to try to improve our knowledge, but it has traditionally been true, I believe, that small loans have been priced somewhat higher than large loans, and I would leave it to somebody in the banking industry to explain just why that seems to be the case.

Mr. **Nowak**. All right, fine. We appreciate your testimony, Mr. Swain, and we'll be looking forward to receiving the answers to the other questions that we put to you.

Mr. **Swain**. Thank you, Mr. Chairman.

Mr. **Nowak**. We're going to hold the record open for that response and others. Thank you very much once again.

Our next witness is from the National Federation of Independent Businesses. We have William Dennis who is director of research for NFIB; if he'll come forward. He's certainly no stranger to the subcommittee, having testified on a variety of issues on behalf of NFIB.

Also I must acknowledge that he has been with NFIB for the past 7 years and has been the author of a number of studies which have been undertaken and published by the NFIB, and we want to welcome you once again.

TESTIMONY OF WILLIAM J. DENNIS, JR., DIRECTOR OF RESEARCH, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Dennis**. Thank you, Mr. Chairman. It's good to be back. I always enjoy being before this subcommittee. It tends to take up issues that are of enormous interest and concern to small business, and we appreciate that.

A good portion of my remarks will come out of the publication, "Credit Banks and Small Business." I believe everyone has a copy.

From time to time I will refer to page numbers, and things of that nature, so you might have it handy. It would be helpful.

On balance, NFIB believes that the deregulation of banking has not been particularly helpful to smaller firms. While individual portions, individual movements have been positive, the balance has not proven to be of benefit to small business. The problem, however, is that other economic conditions have fogged the whole issue. It's very difficult to disaggregate what's happened in bank deregulation from what's happened to the economy as a whole.

The question of $200 billion deficits is a good example. It is probably too early for a definitive judgment of banking deregulation. However, if we don't make judgments now, a structure may be in place at a time when we can make judgments that we don't like. So, indeed, it is not too early to begin making at least some tentative determinations. I would like to explain, or at least to describe as best I can, some of the major changes that have occurred in the small business debt market since institution of banking deregulation. First of all, the question of most interest is rates. Rates have been high by any post-World War II historical measure.

It's curious, however, because as we have watched the spread between the small business rate on short-term loans and the prime, we have found that since the very late 1970's through about mid-1982, that when we were on this roller coaster, the small business rate tended to lag the prime.

As the prime began to rise very rapidly, the small business rate at times was a little bit lower than the prime, and then as rates came down the same thing happened: The spread increased.

The problem is that about three to four quarters ago that ceased. In fact, if I may call your attention to page 20, chart 6 of this particular publication. John, would you give them this copy of the quarterly economic report?

OK, I am sorry. Let me just explain this chart. What we have here is the spread between prime and the small business rate on short-term loans. What we see is that through 1980, 1981 and into 1982, that the difference is relatively small.

At times it's even negative, meaning that small businesses, on average, received a better rate than prime. However, three quarters ago, actually it's been almost 1 year now, things changed. The spread is now up to almost 3 percentage points, which is an enormous difference.

I have been pursuaded that to some degree prime is a political rate. It's not a real rate, and so if you look at the difference between the small business rate and the Federal funds rate as being perhaps a bit more representative of what the true market value is, then you find that the differences are not quite so extreme. Nonetheless, change that occurred three to four quarters ago remains.

Another major difference is that we are finding, and not surprisingly, fewer fixed rates. Virtually all small firms received fewer in the late 1970's and early 1980's. That's no longer the case. In fact, over one-third of all loans extended to smaller firms are now on a variable rate of some type or another.

We also find that there is a shortage of longer term money. We have no evidence as to the vintage of this phenomenon. We're not sure whether this is a post-1979 phenomenon, a pre-1979 phenomenon or what, but it's clear that it is difficult for small businesses to get loans of duration, 5 years and more. It is not surprising because the markets are very, very shakey for obvious reasons about extending loans for longer periods of time.

We also find that the extraordinary or extreme differences between rural and urban areas has changed enormously over the period. In the late 1970's and early 1980's it was clear that rural banks charged substantially less for their loans than did urban banks.

Since that time, however, we have clearly entered a national market. Funds that small local rural banks are obtaining now are just as expensive as are those in urban centers. Those rates have been passed on to consumers.

We also find that the banking services desired by small businesses are not necessarily those services which are provided to the greatest extent by commercial banks. This doesn't necessarily have anything to do with banking deregulation per se.

A large difference we find has been among large banks and banks in branching States vis-a-vis small banks and banks in unit States. As a general rule small banks, those in unit States and rural banks have tended to provide or at least be evaluated by small businesses as providing more of the kinds of things that they have wanted than have others.

They have been ranked better on the provision of these services. They have been ranked better on such objective measures as prices charged, loan rejections, things of that nature. So what does this portend to the future? Well, obviously if current trends continue, it's not particularly good. Small businesses heavily depend on debt capital.

Our study shows that 85 percent of small businesses had as their last source of funds a commercial bank. The next biggest source, by the way, were private individuals, so if these funds continue to stay at a very, very costly level, then this obviously is not in the best interest of smaller firms.

Second thing is that we are centralizing our system into a series of large banking institutions. This also appears not to be particularly helpful to smaller firms. The empirical data indicates that these firms are not as responsive as smaller firms are to small business.

Why?

We're not certain. However, it appears to have two sources, and certainly we think that these hypotheses if you wish to call them that need further testing. The first one is the loan officer per se, but not necessarily for the reasons that Professor Shapero's research provides. If you are in a situation where a loan officer is moved from bank to bank, if you are in a situation where the loan officer does not live in the basic neighborhood or community that he is asked to serve, if the loan officer has more than a one-product line then he has a very high transaction cost everytime he goes to make a small business loan.

In other words if you are in a neighborhood, live in a neighborhood, you've been there for 30 years, you've been at that bank for 30 years, you know the businesses? You know the people running those businesses?

If you've been there 1 year or 2 years you don't know those people, you don't know those businesses. All of a sudden the transaction costs between the evaluation of a loan application on those two are enormously different, so there's one reason.

Second reason is that in the smaller banks, the decisions could be made locally. The very important decisions can be made locally. We don't have to go up a chain of command.

Now the larger banks can reduce some of these problems by giving more autonomy to their local branches, and by tending to keep people in areas or at particular establishments; however, it's questionable whether or not they can ever better smaller banks.

Thus, the movement toward large institutions is not necessarily in the best interest of smaller firms. Thank you very much.

[Mr. Dennis' prepared statement with attachments follows:]

PREPARED STATEMENT OF WILLIAM J. DENNIS, JR., DIRECTOR OF RESEARCH, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

On behalf of the National Federation of Independent Business [NFIB] and its more than 570,000 members nationwide, we appreciate this opportunity to express our concerns about the deregulation of banking institutions. Amid all the recent clamor over deregulation, it is generally argued that, whatever the consequences for individual institutions, the ultimate winners will be the consumers of banking services. Unfortunately, there is precious little hard evidence to support this contention, especially in the case of one of the major consumers of credit—small business.

Let's look at the existing data. It is generally recognized that credit provided by banks is a critical source of financing for small firms, which traditionally don't have access to the stock, bond, and commercial paper markets or internal resources for raising capital. A recent survey of NFIB members shows that more than 85 percent of loans to operating small businesses are provided by commercial banks, as compared with between one and three percent provided by government sources, finance companies, or S&Ls. Meanwhile, a 1982 survey of banks conducted by the Interagency Task Force on Small Business Finance found that three quarters of all bank loans to small firms were made by small- and medium-sized banks. Moreover, that study showed that loans to small firms make up 95 percent of the commercial loan portfolio at small banks and 77 percent at medium-sized banks, as compared with only 13 percent at large banks.

These studies document the importance of banks, especially smaller banks, in meeting the credit needs of existing small firms. They also provide extremely useful insight into how well banks are performing in this relationship. The Interagency Task Force study found that small banks were charging lower interest rates on small business loans than medium- and large-sized banks in three different categories of loan maturity. The NFIB study found that small businesses received higher approval on loan applications and lower interest rates in unit banking states where multi-bank holding companies were restricted (typically smaller banks) than where statewide branching and multibank holding companies were allowed. These data contradict the widely-made claim that unlimited branching automatically increases competition in banking and thus increases the availability of credit while reducing its cost. And they make it clear that the changes taking place in banking, if they are to continue, will have major implications for the financing of small business.

The deregulation of interest rate ceilings on deposits has already had a dramatic effect. Banks now have to pay higher rates on their core deposits, in turn increasing what they have to charge on loans. With banks currently paying eight or nine percent to attract deposits, and allowing for a two or three percent spread, we may never again see business loans under ten or eleven percent. In fact, for the past three quarters, our members have been paying an average of about 3 percentage points above prime. While it is true that depositors are receiving higher rates, business checking accounts still do not pay interest, and small firms rarely have the cash needed to utilize professional cash management accounts.

Depositors have also shifted their money into shorter-term instruments. As their liabilities have shortened, banks are less willing to make long-term commercial loans. Such loans are very important to small firms because they enable them to plan their cash flow and spread interest payments out over time as the business grows. NFIB's study found that 47 percent of all loans were for less than one year, while only 13 percent were longer than five years. Even more disturbing was the fact that some small companies have been forced to use short-term credit for expenditures which are best suited by long-term loans (e.g. plant and equipment).

In the area of product deregulation, existing small businesses face the prospect of having to compete directly with the banks which are chartered to serve them. The Administration's Financial Institutions Deregulation Act, currently before Congress, would allow banks to sell insurance and engage in real estate and securities brokerage through bank-owned subsidiaries. Small firms engaged in these lines of business rely heavily on banks for credit and may be at a disadvantage when asking a bank that operates a competing subsidiary for a loan. There are also questions of illegal tie-ins between a bank's loan making function and its other commercial ventures. Moreover, banks iffer the appeal of federal insurance and have an essentially captive walk-in clientele which subsidiaries can easily tap. Pressure to expand the laundry list of ventures banks may enter is strong and will likely increase as banks argue that they cannot survive without greater commercial powers.

The third major area of deregulation concerns geographic restrictions on where banks can operate. While interstate banking gets a great deal of attention in the media, Congress has not yet even considered lifting geographic restrictions and is not likely to soon. Congress doesn't have to, because bank holding companies are successfully evading the restrictions, anyway. Bank of America, the largest bank in the U.S., just purchased the largest bank in Washington state, and numerous other mergers have been sweeping the industry. Even experts who favor interstate banking argue that existing anti-trust laws will not prevent a wave of mergers and acquisitions of small banks by larger ones if geographic restrictions are lifted. A recent major study conducted by the Bank Administration Institute and Arthur Anderson and Company projected that 40 percent of the banks in the U.S. will disappear by 1990. However, large banks are expected to increase by 26 percent. Already more banks have failed in 1983 than in any year since 1941, and nearly 600 banks are currently listed as problem banks by the FDIC. Most of the failed or troubled banks are small institutions. This has to raise serious concerns about undue economic concentration and the continued availability of credit for small firms.

A final point for consideration is the entry of non-banking companies into banking, especially by establishing "non-bank" banks. To date all "non-bank" banks that have applied or been approved for a charter excluded commercial lending from their activities in order to escape regulation as a bank holding company. In some cases, this has meant divesting an existing bank's commercial loan portfolio. For the community of Hapeville, Georgia, Prudential's purchase of a small local bank means divestitute of the bank's commercial loans and the elimination of the only source of commercial credit for 30 miles. As banking decisions are made further and further away from the source of deposit taking by larger corporate conglomerates, whose principal reason for buying a bank may be to finance the purchase of its own products, the ability of small firms to obtain the credit they rely upon will be weakened.

Having made these points, it should be noted that NFIB has generally been a strong supporter of easing government regulation and is well aware of the need for adapting to changes in the financial industry. For example, allowing banks to pay interest on business checking accounts would help small companies in their management of cash. Allowing thrifts to make commercial loans should increase the sources of credit for small business. But NFIB's members have voted overwhelmingly against interstate banking and extended commercial powers for banks. They remain unconvinced that the headlong rush to deregulate banking will serve their interests.

Along with my testimony today, I am submitting copies of NFIB's 1983 report entitled "Credit, Banks and Small Business" for the committee's consideration. It is the most complete data source regarding the relationship between small business and banks currently in existence. We will be conducting the survey of our members again in April of 1984 and will be happy to keep the committee informed of the results.

NFIB® CREDIT, BANKS AND SMALL BUSINESS

MAY 1983

FOREWORD

If any single word could describe events in the financial markets over the last five years, it would be "change." The rapid growth of money market mutual funds in response to the removal of Regulation Q ceilings, partial deregulation on the liability side of balance sheets in banking and thrift institutions, the issuance of jumbo CD's tied to Treasury Bill rates, a new monetary policy from the Federal Reserve, the Depository Institution Deregulation and Monetary Control Act of 1980, and historically high and volatile interest rates were just some of the more obvious examples--and more change lay ahead. Because of the importance to small business of the financial markets in general and the banking system in specific, NFIB felt it necessary to assess and report the impact of these changes on smaller firms.

This study, Credit, Banks and Small Business, is primarily based upon two surveys of the same name conducted over random samples of the NFIB membership in April, 1980, and April, 1982. However, data have been integrated from How Small Businesses Begin (November, 1979) and the Quarterly Economic Report for Small Business (quarterly, since October, 1973) to provide a more comprehensive view of the entire small business/commercial bank relationship.

Single copies of this report are available at no charge by writing NFIB.

Research Department

CREDIT, BANKS AND SMALL BUSINESS

by

Jonathan A. Scott
Southern Methodist University

and

William C. Dunkelberg
Purdue University

The ability of small business to access credit markets in order to finance new business starts or existing operations is critical to the health of the U.S. economy. Small business produces an estimated 43 percent of the Gross National Product, employs 56 percent of the private workforce, produces a disproportionate share of new jobs and innovations, and often is the "seed" for major industries of the future.[1/]

The need to analyze small business and its relationship with financial markets arises from a concern over the adequacy of capital flows to this important sector of the economy. "Conventional wisdoms" of questionable validity frequently appear in the financial press and in policy discussions. For example, it is often asserted that small business is the first group to be rationed out of the market when credit gets "tight." That or similar assertions may or may not be true, but if any hard data underly them, it usually consists of interviews with a few entrepreneurs or impressions of "knowledgeable" people. The unfortunate result is a series of questionable premises underlying a collective frame of reference.

In an environment of "deregulation," the potential effect of liberalized branching laws (i.e. interstate banking) on small businesses' ability to obtain credit is also of major interest. Several studies have suggested that bank customers would be better served with less restrictive branching laws.[2/] The conclusions of these studies have been based upon aggregated bank data which typically use a Standard Metropolitan Statistical Area (SMSA) as the relevant market. For most small firms, the SMSA is too large an area to measure relevant bank performance. Furthermore, the use of aggregated bank data precludes analysis of individual loan rates, collateral requirements, problems with credit availability, or assessment of the non-price dimensions of a banking relationship (such as the reliability of banks as a steady source of credit).

This report presents a comprehensive study of small business participation in financial markets. Two surveys of the membership of the National Federation of Independent Business conducted in

April 1980 and 1982 were used as the basis for the study. The surveys provided descriptors of the firm (form of business, industry classification, years in business, sales, employment), data on the most recent loan acquired (size, maturity, interest rate, purpose, collateral), and data about the firm's banking relationship and credit market, including information on credit availability, loan term satisfaction, perceptions of bank competition for its business, and rankings of major bank performance on characteristics deemed important in a banking relationship. There were 2657 respondents to the 1980 survey (a response rate of 33 percent) and 2349 respondents to the 1982 survey (a response rate of 31 percent).

The major findings of this report are:

- Most firms were able to satisfy their financing needs.
- Problems with credit availability were related to characteristics of the firm that in turn are correlated with the risk of default.
- Small firms do not always pay more than the prime rate. Few respondents paid more than 2 points over the prime rate.
- The average rate paid was rarely more than 150 basis points above the prime rate. When the prime was rising (falling), the difference narrowed (widened).
- Differences in rates paid by market size (urban-rural) and branching laws existed in 1980, but were substantially eliminated by 1982.
- Small firms were more likely to be solicited by a bank in metropolitan areas, statewide branching states, and in communities with more than four banks.
- Banks performed best in providing small firms with locational convenience, a wide range of services, and in having a single person to handle the firm's credit needs.
- Banks in unit banking states and rural banks generally performed better than branching states and metropolitan banks on the characteristics most desired in a banking relationship.

The conclusions drawn in this study are probably generalizable to the larger small business population. Comparisons of government data and NFIB samples suggest that, with few exceptions, the NFIB membership (and samples drawn from this membership) are representative of the firms in the U.S. small business sector.

I. Small Business Borrowing

A. Sources of Small Business Loans

The sources of capital for starting a new firm are substantially different from those used by the firm once its business operation is established. The findings from a 1979 study of small business starts are reported in Table 1.[3] Among firms started by their current owners (not inherited or purchased), the study found that 40 percent relied on one major source of credit. Over half of these firms (17 percent of all firms started) reported their own personal resources as the single major source of funds. Nine percent of all firms relied primarily on funds obtained from institutional lenders (principally banks, but some finance and insurance companies). Friends, relatives and unrelated individual investors accounted for the remainder. Government and venture capital firms were negligible sources of funds.

Table 1

SOURCE OF FINANCING NEW SMALL BUSINESS[1]

One Major Source	All Firms	Starts[1]
Personal Savings	17	23%
Friends; Relatives	4	2
Institutional Lender	9	7
Individual Investor	4	3
Venture Capital	*	*
Government	1	1
Other Source	5	4
	40%	40%

Two Major Sources[2]	All Firms	Starts[1]
Personal Savings and:		
Institutional Lender	18%	23%
Friends; Relatives	9	11
Individual Investors	2	2
Friends; Relatives and:		
Personal Savings	5	3
Institutional Lender	4	2
Institutional Lender and:		
Personal Savings	12	11
Friends; Relatives	4	3
	54%	55%
Other Pattern; No Answer	6%	5%
Total	100%	100%
Number of Firms	1805	890

---

[1] Firms that were started by their owners (not purchased or inherited).
[2] Most important listed first.
* Less than 0.5 percent.

Source: How Small Businesses Begin (November, 1979), National Federation of Independent Business, unpublished.

Most interesting were the firms still owned by the entrepreneurs who started them. Fifty-five percent reported two major sources of funds. For nearly 60 percent of these (36 percent of all starts), personal savings were the major source of capital, in combination with funds from institutional lenders (23 percent of all starts), and with money from friends and relatives (9 percent of all starts). Institutional lenders were the primary sources for nearly 11 percent of the multi-source starts (14 percent of all starts)--almost always in combination with personal savings.

Overall, personal savings played a major role in 63 percent of the new business starts, while institutional lenders were important capital sources in 47 percent of the cases. Friends and relatives were major capital sources in 26 percent of the new ventures.

The pattern was considerably different for firms which were purchased or inherited. The contribution of personal resources in these types of business originations diminished, although personal resources remained important. The primary factor differentiating purchases and inheritances from starts is the enhanced role of lending institutions. Established businesses have a "track record" plus certain other inherent advantages, e.g. an established customer base which reduces lender risk. The lender is more willing to extend loans in such instances.

Once the firm is established, credit needs change, with the emphasis shifting from personal sources to institutional ones--primarily banks. About 85 percent of loans to operating small businesses come from banks, with private individuals accounting for another 5 percent (Table 2). Government sources, finance companies, S&Ls and insurance companies each comprise 1 to 3 percent of the remaining loans.

Over 90 percent of the short-term loans (1-12 month maturity) were from banks. The proportion of loans financed at banks declined as maturity increased, with banks providing over 70 percent of loans with maturities of five years or more. Private individuals and finance companies picked up the share of medium-term loans not made by banks. For the longest maturities, private individuals and S&Ls were more active lenders, with S&Ls providing mostly mortgage financing. Between 1980 and 1982, however, the S&L share of long-term loans fell three percentage points. This reduced financing by S&Ls is attributable to the effect of deregulation on the cost of funds and its effect on commitments for long-term lending.

Government sources provided 4 percent of the long-term loans, the public's highest participation in the financing of operating firms, and proportionately four times larger than its financing role in the starting of new firms. Fifty-five percent of the firms

Table 2

SOURCE OF SMALL BUSINESS CREDIT
BY LOAN MATURITY (MONTHS)

	Maturity (Months)							
	1 - 12[1]		13-60		Over 60		All Loans[2]	
Loan Source	1980	1982	1980	1982	1980	1982	1980	1982
Bank	90%	91%	82%	78%	70%	73%	85%	84%
Private Individual	4	4	5	8	9	10	5	6
Government	1	*	2	1	4	4	1	1
Finance Company	1	1	4	5	2	2	2	2
Insurance Company	1	*	1	1	1	2	1	1
Factors/Credit Cards[3]	*	*	*	*	*	*	*	*
Co-op	1	1	1	1	1	1	1	1
Savings & Loan	1	1	1	2	7	4	2	2
Other	1	2	4	4	4	4	4	3
	100%	100%	100%	100%	100%	100%	100%	100%
Number of loans	1170	968	602	605	269	253	2218	1947

---

[1] Includes Revolving Credit.

[2] Includes 85 no answers in 1980 and 122 no answers in 1982.

[3] In 1980, "Factors," and in 1982 "Credit Cards" were offered respectively as financing source choices.

* Less than 0.5 percent.

in the 1980 survey reported not knowing of any government small business lending program (Table 3). (The series of questions related to government programs was not repeated in 1982.) Firms were most aware of the SBA (Small Business Administration) guaranteed loan and SBA direct loan programs. Knowledge of Economic Development Administration (EDA) programs was virtually non-existent. Only 5 percent of the firms reported using a government assistance program within three years of the survey. Of those that reported using a program, 68 percent used the SBA guarantee, while 22 percent used the SBA direct loan. Of those that did not use a government assistance program, lack of need was the most frequently reported reason (36 percent), while 19 percent reported that they had never thought about it. Over 25 percent reported that they did not use the programs because of too much red tape, while 10 percent did not use them because of the difficulty in understanding the program procedures. Government-supported small business lending programs were not important to this sample of small firms.

Table 3

USE OF GOVERNMENT ASSISTANCE PROGRAMS

Knew About Assistance Programs		Percent Reporting
Yes		45%
SBA Loan	39%	
SBA Guarantee	47	
EDA Loan	4	
EDA Guarantee	4	
State Loan	6	
No		55%
		100%
Used Assistance Program in Last Three Years		
Yes		5%
SBA Loan	22%	
SBA Guarantee	68	
EDA Loan	2	
EDA Guarantee	5	
State Loan	3	
No		86%
Did not need	36%	
Did not qualify	5	
Money not available	1	
Bank did not participate	4	
Too much paperwork	25	
Program not understandable	10	
Never thought about it	19	
No Answer		9%
		100%

B. Characteristics of Small Business Borrowers

At one time or another most small businesses borrow money. Over 90 percent of all firms have borrowed at some time in their history (Table 4). Over 50 percent of all firms borrow at least once per year. The remainder, about 40 percent, borrow less frequently.

Not all firms have the same capital needs, so borrowing activity will vary substantially by such characteristics as firm size or industry. For example, the proportion of regular borrowers rises from a low of 42 percent for firms with annual sales of $50,000 or less to 68 percent of firms with sales of $3 million or more

(1980). A similar pattern was observed when using total employment and asset size, both generally related to firm sales levels.

Frequent borrowing activity was more likely to occur in firms that have been in business between three and fifteen years. Firms in business under three years pose the highest risk to lenders, while firms in business three years or more typically have passed the critical stage of survival and become better credit risks. Their borrowing frequency then tends to increase, supporting growth after the initial critical period. Firms in business over 15 years have usually made the decision to remain at their current size. With growth stabilized, borrowing needs diminish.

Rapid growth typically requires more capital than the firm can generate internally or the owners can provide. In 1980, 69 percent of the firms with rapidly expanding sales borrowed regularly, compared to 52 percent of the firms with steady growth. The difference was also present in 1982, although borrowing activity was lower for all firms than in 1980. Lower credit demands were due to the recession, lower inventories and the failure of many marginal firms. In both years, borrowing rates for firms with declining sales were higher than for firms with steady sales. This is, in part, a function of the "survival" borrowing resulting from the squeeze imposed on cash flows due to rising costs or declining demand.

Industry credit demands varied widely. The most frequent borrowers were found in construction, transportation, the wholesale trades and agriculture, where fixed capital or inventory requirements are substantial, and/or seasonal factors produce a major mis-match between revenues and costs. Firms in the service industries and retailing were the least frequent "regular" borrowers. These relative differences were present in both 1980 and 1982.

Heavy agricultural borrowing activity helps explain why firms in rural areas exhibited the highest average rate of frequent borrowing in 1980 and 1982. In 1980, firms in metropolitan areas were the most frequent regular borrowers, but the percentage fell from 60 percent in 1980 to 49 percent in 1982. Regional differences in borrowing activity were also substantial. Borrowing activity in both years was highest among firms in the West North Central region, which has an economy heavily dependent upon agriculture. Borrowing activity was consistently higher in the Mountain states and West South Central states than in most other regions, probably reflecting both the high demand for energy related loans and relatively strong overall regional economic growth.

A substantial decline in borrowing activity occurred between 1980 and 1982. The late 1970's were characterized by an economic

Table 4

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

			Borrowing Activity					
	Percent of Firms[1]		Frequent Borrowers[2]		Infrequent Borrowers[2]		Non-Borrowers[2]	
Characteristic	1980	1982	1980	1982	1980	1982	1980	1982
All Firms	100%	100%	56%	52%	35%	41%	8%	6%
Gross Sales: (thousand $)								
under 50	8	8	42	39	44	50	14	11
50-99	11	11	50	51	42	40	8	9
100-200	17	15	57	47	34	46	9	7
200-350	15	15	53	49	37	45	10	6
350-500	9	10	59	57	34	40	7	3
500-800	9	10	56	51	37	43	7	6
800-1,500	12	12	66	61	28	36	6	3
1,500-2,999	7	8	64	62	31	35	5	3
3,000 or more	9	10	68	63	30	33	2	4
Fulltime Employment:								
one	10	7	50	43	34	45	16	12
two	10	9	53	46	38	48	9	6
3-5	29	28	53	49	38	43	9	8
6-9	18	18	55	54	38	42	7	4
10-14	10	11	61	57	31	38	8	5
15-19	5	5	64	59	29	38	7	3
20-39	9	9	67	61	30	38	3	1
40 or more	9	8	64	60	33	34	3	6
Years in Business:								
1-2	9	6	44	51	44	42	12	7
3-4	12	10	61	58	31	36	8	6
5-6	9	9	62	59	31	35	7	6
7-10	16	16	60	54	34	41	6	5
11-15	12	12	64	54	30	40	6	6
16-20	10	9	57	52	36	44	7	4
Over 20	32	37	52	50	38	44	10	6
Annual Average Sales Growth[3] (Past 2-3 Years)								
Over 20% (rapid)	10	15	69	60	28	34	3	6
11-20% (growing)	46	16	60	53	34	43	6	4
6-10%		22		51		42		7
0-5% (steady)	26	20	52	49	41	47	7	4
Declined	11	19	58	57	34	38	8	5
Too New to Measure	2	4	39	47	48	46	3	7

Table 4 (continued)

Characteristic	Percent of Firms		Borrowing Activity					
			Frequent Borrowers		Infrequent Borrowers		Non-Borrowers	
	1980	1982	1980	1982	1980	1982	1980	1982
Industry:								
Construction	15	15	68	63	24	31	8	6
Manufacturing	12	12	56	51	39	43	5	6
Transportation	3	3	70	63	23	37	7	0
Wholesale	8	8	61	54	33	43	6	3
Retail	33	33	52	49	38	45	9	6
Agriculture	5	5	73	74	21	21	6	5
Financial	8	7	56	48	31	44	13	8
Service	10	11	41	43	50	48	9	9
Professional	6	6	51	49	43	44	6	7
Value of Assets: (thousand $)								
Under 25	na	6	na	43	na	45	na	12
25-49		7		46		48		6
50-99		15		48		46		6
100-249		21		54		41		5
250-499		16		58		38		4
500-999		11		62		33		5
1,000-4,999		9		62		36		2
5,000 or more		2		70		26		4
Location:								
Rural	40	41	59	54	34	40	7	6
Small City	30	30	56	53	36	42	8	5
City	19	20	54	51	38	43	8	6
Metropolitan	8	8	60	49	35	46	5	5
Region[4]:								
New England	5	5	44	47	50	48	6	5
Mid-Atlantic	10	10	52	47	42	44	6	9
E. N. Central	16	18	59	51	35	44	6	5
W. N. Central	13	14	62	64	31	33	7	3
S. Atlantic	10	11	51	47	38	46	11	7
E. S. Central	4	4	52	49	42	44	6	7
W. S. Central	11	11	63	58	31	37	6	5
Mountain	9	9	61	61	30	33	9	6
Pacific	18	18	54	46	34	46	12	8

---

[1] Does not add to 100% since firms not reporting a value for each characteristic are omitted.

[2] Frequent borrowers: at least one time per year; infrequent borrowers: less than once per year; non-borrowers' no borrowing reported at any time.

[3] In 1980, only the verbal categories were used.

[4] Department of Commerce classifications.

na not asked.

expansion accompanied by unusually high inflation and interest rates. Total borrowing in the economy expanded rapidly, and small business was no exception. The percent borrowing at least once every three months increased 10 percentage points (from 40 to 50 percent) between 1977 and early 1980 (Table 5). Borrowing activity has declined since that time, except during the brief expansion after the major economic downturn in the second quarter of 1980. By early 1982, quarterly borrowing had dropped ten percentage points to 40 percent of all firms, a level of activity typical of small business borrowing as the economy emerged from the 1974-75 recession.

Table 5

BORROWING BEHAVIOR OF ALL FIRMS

Year/ Quarter	Percent Borrowing[1]	Year/ Quarter	Percent Borrowing[1]	Year/ Quarter	Percent Borrowing[1]
1973 III	40	1977 I	40	1980 I	50
IV	39	II	41	II	41
		III	40	III	43
1974 I	41	IV	38	IV	45
II	45				
III	42	1978 I	47	1981 I	44
IV	38	II	47	II	45
		III	46	III	43
1975 I	42	IV	51	IV	40
II	39				
III	39	1979 I	na	1982 I	40
IV	39	II	46	II	41
		III	48	III	42
1976 I	39	IV	46	IV	40
II	39				
III	40				
IV	40				

---

[1] Percent of all firms, borrowing at least once every three months. Surveys are taken in the month following each quarterly period.

na not asked.

Source: Quarterly Economic Report for Small Business, National Federation of Independent Business, various editions.

II. Small Business Loan Characteristics

A. Size

In both surveys, almost half of the loans were under $20,000. Loan size was related to maturity. Short- and medium-term loans were the smallest, with about 50 percent amounting to less than $20,000. Long-term and revolving credit loans were the largest. Over 50 percent of the revolving credit loans were in excess of $100,000, and over 60 percent of the long-term loans were in excess of $40,000.

The average loan size increased by almost $6,000 between 1980 and 1982 (Table 6). This increase, 4 percent compounded annually, was less than the rate of inflation. Thus, the average real amount borrowed fell. All of the increase in the average loan size was due to an increase in the size of long-term loans, which rose by 16 percent per year. Short-term loans remained at about the same level. The average medium-term loan fell by 5 percent per year, and revolving credit loans fell by 7 percent per year. Most of the increase in the long-term loan size was due to the increased incidence of property and expansion loans, which generally were larger.

Loan size increased with firm sales, reflecting the additional debt capacity of larger firms (Table 7). Forty eight percent of the firms with sales in excess of $1.5 million per year reported loans in excess of $100,000 versus only 4 percent with sales under $100,000 per year. Loan size also varied with degree of investment in long-lived assets. Agricultural and transportation firms more frequently reported loans over $100,000, reflecting their greater investment in long-lived capital equipment. Professional, non-professional, and financial service firms, with relatively little plant and equipment and inventory, more frequently reported loans under $10,000.

B. Maturity

About half of the loans in each survey were short-term, i.e. a reported maturity of twelve months or less (Table 8). Revolving lines of credit comprised only four percent of the reported loans in 1980 and three percent in 1982. Medium-term loans (13 to 60 months) were reported by about 30 percent of the firms in both surveys; long-term loans (61 months or more) were reported by about 12 percent of the firms.

Although the incidence of frequent borrowing fell between 1980 and 1982, a higher proportion of the firms responding to the 1982 survey had been recent participants in the credit market. In the April 1980 survey, 74 percent of those that reported a short-term loan had obtained the loan within a year of the survey; this

Table 6

LOAN SIZE BY LOAN MATURITY

Loan Size: (thousands $)	All Loans 80	All Loans 82	Short-Term 80	Short-Term 82	Medium-Term 80	Medium-Term 82	Long-Term 80	Long-Term 82	Revolving Credit 80	Revolving Credit 82
Under 5	14%	13%	67%	59%	26%	32%	1%	1%	1%	2%
5-9	16	15	57	47	31	44	4	3	2	1
10-19	18	21	57	49	28	37	7	6	4	2
20-39	20	17	51	49	28	28	15	13	3	3
40-69	12	11	43	48	31	24	19	17	3	3
70-99	4	4	41	37	29	34	27	23	2	1
100-149	5	6	41	28	24	26	20	35	11	1
150-199	2	3	35	45	17	16	33	22	9	9
200-299	3	3	34	32	23	20	28	33	11	6
300-399	1	1	47	46	13	14	28	25	9	7
400-599	2	3	29	37	27	15	22	33	22	4
600-999	1	1	32	24	12	16	24	44	24	12
1,000-2,000	1	1	31	33	19	8	25	42	13	0
Over 2,000	*	1	50	10	10	20	30	40	10	10
All Firms	100%	100%	52%	47%	27%	31%	12%	13%	4%	2%

Maturity	Mean Loan Size 1980	Mean Loan Size 1982	Median Loan Size 1980	Median Loan Size 1982
1-12 months	$ 54,950	$ 54,130	$ 14,580	$ 14,960
13-60 months	55,150	49,840	19,250	13,550
61+ months	145,620	195,950	50,070	78,500
Revolving Credit	201,360	176,860	50,500	40,160
All Loans	$ 72,800	$ 78,630	$ 19,780	$ 19,610

proportion rose to 81 percent in the April 1982 survey. Larger shifts occurred for medium- and long-term loans. The proportion of medium-term loans obtained within a year of the survey rose from 53 percent to 70 percent, and the long term proportion rose from 37 percent to 61 percent.

The maturity composition of the reported loans changed between the surveys (Table 9). Between 1980 and 1982, the proportion of short-term loans made fell six percentage points (from 53 to 47 percent). Within the short-term category for both surveys, over 40

Table 7

FIRM AND LOAN CHARACTERISTICS BY LOAN SIZE

			Loan Size													
	Total		Under $5000		$5000-9999		$10,000-19,999		$20,000-39,999		$40,000-99,999		$100,000-299,999		$300,000 or more	
Characteristics	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Firm's Annual Sales: (thousand $)																
under 50	7%	7%	46%	42%	19%	24%	13%	19%	14%	9%	4%	4%	2%	1%	2%	1%
50-99	12	11	28	20	27	19	21	24	14	15	6	9	4	3	*	*
100-199	17	16	19	21	28	25	24	26	12	13	11	8	5	6	1	2
200-349	16	15	13	11	18	19	23	26	24	18	14	16	6	8	1	2
350-499	9	10	10	10	16	14	27	30	25	18	14	17	5	8	3	3
500-799	9	10	4	5	10	14	21	26	32	25	20	16	9	12	4	2
800-1,499	12	12	2	2	6	8	16	19	28	27	28	26	17	13	3	5
1,500-2,999	8	8	2	2	4	5	7	12	24	21	31	25	24	26	8	9
3,000 or more	9	9	2	1	4	0	2	3	14	9	16	19	30	32	32	36
No Answer	1	2	14	17	30	17	18	21	25	15	9	24	4	2	0	4
Industry:																
Construction	16	15	10	8	15	14	19	22	18	21	18	16	14	13	6	6
Manufacturing	12	12	10	9	11	9	17	22	19	15	19	19	10	17	12	9
Transportation	3	3	6	0	9	10	25	25	21	18	22	16	12	11	7	20
Wholesale	8	7	4	6	9	7	11	16	24	20	25	22	19	16	9	12
Retail	33	34	18	16	19	17	17	22	20	16	15	15	8	10	3	4
Agriculture	5	5	8	4	10	10	18	12	23	19	18	21	14	23	10	12
Finance	7	7	11	13	22	19	25	17	22	21	8	16	9	9	4	6
Services	10	11	25	30	20	18	20	21	19	13	8	11	5	4	3	2
Professional	6	6	17	15	22	22	23	27	25	18	9	10	2	4	2	2
No Answer	*	*	0	14	20	0	0	14	40	29	20	14	20	0	0	29
Loan Purpose:																
Inventory	25	20	13	12	13	16	17	22	20	20	18	17	10	8	6	5
Tax, Payroll, Debt	27	24	13	18	16	13	21	24	21	22	13	11	8	9	5	2
Maintenance	14	18	17	15	29	19	18	24	16	14	8	12	7	9	2	7
Property	8	7	7	7	11	9	14	16	23	18	19	20	13	21	9	9
Expansion	22	25	10	6	12	13	15	18	22	14	20	18	14	18	6	11
No Answer	4	7	24	18	13	12	14	19	19	21	10	17	12	7	4	4
Total	100%	100%	13%	12%	16%	14%	18%	21%	20%	18%	16%	15%	10%	12%	5%	6%

---

* Less than 0.5 percent

Table 8

Year Last Loan Obtained By Loan Maturity

April 1980 Survey	(Months) 1-12	13-60	61 or More	Revolving Credit	All Firms[1]
Date of Loan					
1980 I	42%	21%	14%	54%	33%
1979 IV	16	13	8	8	14
1979 III	8	10	7	10	8
1979 II	8	9	8	8	8
Prior to 1979 II	21	44	56	19	32
Not Ascertained	5	3	7	1	5
Number of Loans	1170	602	269	96	2218
Percent of Total	53%	27%	12%	4%	100%
April 1982					
Date of Loan					
1982 I	45%	29%	15%	23%	33%
1981 IV	17	18	21	15	18
1981 III	10	12	11	8	10
1981 II	9	11	14	13	11
Prior to 1981 II	16	28	36	33	23
Not Ascertained	3	2	3	8	3
Number of Loans	916	605	253	52	1948
Percent of Total	47%	31%	13%	3%	100%

---

[1] Includes 85 "no answers" in 1980 and 122 "no answers" in 1982.

percent of the loans were three months or less, and the mean maturity was about six months. Most of the drop in short-term loans was offset by gains in medium-term maturities. Medium-term maturities increased from 27 percent to 31 percent of all loans. Although the average maturity remained at 41 months in both years, the medium-term maturities reported in 1982 increased in the "25-36" month category by five percentage points and decreased four percentage points in the "49-60" month category. The proportion of long-term loans increased slightly from 12 to 13 percent, but the average maturity increased by almost 15 months between 1980 and 1982. This average maturity increase was largely due to a jump in the proportion of 30 year loans made (not shown in Table 8), rising from 3 to 9 percent of the total long-term loans. Despite the jump in average maturity for long-term loans, the median maturity remained unchanged.

The more recent credit market participation of small business borrowers in the April, 1982, survey was likely attributable to slower overall economic activity and continued high interest rates. Lower inflation and reduced demand forced firms into price cutting, which in turn reduced cash flow. Breaking a pattern established in previous downturns, interest rates did not fall significantly (or at least back to their mid-70's level), further exacerbating small business cash flow problems. This resulted in heavier borrowing to maintain liquidity.

Table 9

LOAN MATURITY

Maturity	Short-Term		Medium-Term		Long-Term	
(months)	80	82	80	82	80	82
1-3	45%	42%				
4-6	28	31				
7-12	27	27				
13-18			5%	4%		
19-24			21	20		
25-36			32	37		
37-48			11	12		
49-60			31	27		
61-96					32%	28%
97-120					35	31
121-180					20	20
181 or more					13	21
Mean Maturity	5.9	6.1	41.2	40.6	140.6	155.4
Median Maturity	5.5	5.7	36.2	36.2	120.0	120.2

The increased frequency of medium and long-term borrowing within a year of the survey did not, however, reflect an attempt by small business to restructure its balance sheet (i.e. convert short-term debt into long-term debt). Instead, this increased medium and long-term borrowing was used for maintenance, property acquisition, and expansion. The proportion of loans used for these purposes rose from 44 percent to 50 percent between surveys. Apparently these firms had profitable investment opportunities and were not going to wait for improved sales to provide sufficient internal cash, or were firms less affected by the down-turn in the economy.

The maturity of the loans were closely matched to their primary use (Table 10). Short-term loans were used primarily for inventory and current liability financing, medium-term loans for maintenance and expansion and long-term loans for property acquisition and expansion. Despite the considerable maturity matching, many small firms used short-term sources of funds for long-term uses. The percentage using short-term funds for long-term purposes jumped between 1980 and 1982. For example, 15 percent of the firms in 1980 used short-term loans to finance property and expansion, while 18 percent did so in 1982. Although this strategy is very risky, these "mis-matched" firms either bet short-term rates would fall in the near future (once rates fell they could refinance long-term and pay a lower average interest cost) or they could not obtain long-term funds indicative of higher risk of default.

Table 10

LOAN MATURITY BY LOAN PURPOSE

			Loan Purpose									
	All Firms		Inventory		Tax, Payroll Debt		Maintenance		Property		Expansion	
Maturity	80	82	80	82	80	82	80	82	80	82	80	82
Short-Term (1-12 mos)	57%	50%	35%	29%	36%	35%	9%	12%	4%	5%	11%	13%
Medium-Term (13-60 mos)	27	31	10	10	17	13	27	31	8	6	34	35
Long-Term (over 60 mos)	12	13	6	6	13	7	10	15	23	15	45	47
All Firms	100%	100%	25%	20%	27%	24%	14%	18%	8%	7%	22%	25%

C. Collateral Requirements

Some form of collateral was required on 62 percent of the loans reported in 1980 and 64 percent of the loans in 1982 (Table 11). Collateral was most frequently reported by firms in the manufacturing, wholesale and agricultural industries, and least frequently reported by firms in the financial and professional services. These industry differences can be partly explained by the relative marketability of the assets serving as collateral. Manufacturing, wholesaling, and agricultural firms usually have plant, equipment, or inventory that could be sold in the event of default. Financial service (primarily real estate and insurance agents) and professional service firms, however, have few marketable assets.

Use of collateral varied by type of lender. Loans from individuals and insurance companies (possibly policy loans) were least frequently secured, while loans from commercial banks were more frequently secured. This difference is not surprising because of the time and expense involved in creating the secured lending agreement and monitoring the use of the collateral. Lenders that do not have experience in making secured loans (e.g. individuals, insurance companies making policy loans) would find the cost exceeding the benefits. The advantage of securing a loan with business or personal collateral is that the lender obtains first claim on those assets in the event of bankruptcy.

This relationship between risk and the frequency of issuing secured debt can been seen in Table 11. As loan size increases, all else being equal, the borrower's leverage increases, thereby increasing the risk to the lender. Accordingly, only 36 percent of the loans under $5000 were reported collateralized, while over 80 percent of the loans exceeding $300,000 were. Collateral was required for about half of the short-term loans, rising to almost 90 percent of the long-term loans. Longer term loans present more risk to the lender if repayment comes from the future earnings power of the firm rather than its ability to sell current inventory or receivables. Newer firms, which are more likely to default, have a higher incidence of secured loans. Almost 70 percent of the firms less than four years old had collateral required, but only 50 percent of those firms in business over 20 years reported a collateral requirement for their loan.

Business assets were most often used as collateral, followed by a combination of business and personal assets (Table 12 and 13). Plant and equipment was most frequently used as business collateral (51 percent), followed by inventory (28 percent), and accounts receivable (17 percent). Homes (37 percent) and securities (17 percent) accounted for over half of the personal collateral, with the remainder taking some other form.

Table 11

COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Percent of All Firms		Percent with Collateral	
	1980	1982	1980	1982
Loan Maturity:				
1-12 months	56%	51%	49%	52%
13-60 months	27	29	73	67
61 months or more	10	11	89	87
Revolving Credit	4	3	67	55
Loan Size: (thousand $)				
Under 5	13	12	36	37
5-9	15	15	52	47
10-19	19	21	56	61
20-39	21	18	65	65
40-99	16	15	71	70
100-299	10	12	76	76
300 or more	5	6	83	82
Years in Business:				
1-2	8	6	71	71
3-4	12	10	68	76
5-6	9	9	64	66
7-10	17	17	67	64
11-15	13	12	61	67
16-20	10	9	60	54
over 20	30	36	49	52
All Firms	100%	100%	62%	64%

Use of accounts receivable, inventory, and plant and equipment as collateral was related to the borrower's industry, loan source, and maturity of the loan. Manufacturing, transportation, and non-professional service firms most frequently provided plant and equipment as collateral; retail and wholesaling firms most frequently provided inventory; and construction, financial, and professional services most frequently provided accounts receivable. Loans from the government and finance companies were more likely to require plant and equipment as collateral than inventory. Finally, short-term loans were more likely to be collateralized by accounts receivable and inventory, while long-term loans were more likely to be collateralized by plant and equipment--a result consistent with the maturity-loan purpose relationship discussed above.

Table 12

COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Total		None		Business		Personal		Business and Personal		Compensating Balances		Other Combinations	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Loan Maturity:														
Short-term	57%	50%	47%	43%	23%	25%	9%	2%	13%	18%	3%	5%	5%	6%
Medium-term	27	31	28	35	36	32	10	5	18	20	1	2	6	7
Long-term	12	13	13	15	37	39	11	8	29	28	2	3	8	7
No Answer	4	6	44	30	25	25	11	3	14	26	*	4	6	11
Industry:														
Construction	16	15	38	36	29	29	8	5	17	20	2	4	5	7
Manufacturing	12	13	32	34	28	32	9	1	20	20	3	4	8	9
Transportation	3	3	42	38	37	31	3	2	15	15	*	5	3	9
Wholesale	9	8	33	30	26	29	8	3	22	23	2	5	7	9
Retail	32	33	38	37	26	29	11	4	18	21	2	3	5	6
Agriculture	5	5	28	31	49	41	1	2	14	17	2	1	6	8
Finance	8	7	48	41	22	17	12	7	7	21	3	8	8	6
Services	9	10	37	37	28	26	13	5	15	22	2	4	5	6
Professional	6	6	44	41	31	32	11	3	10	16	2	2	2	5
No Answer	*	*	20	*	20	1	*	*	40	*	20	*	*	17
Loan Source:														
Bank	85	84	37	35	28	30	10	4	17	21	2	4	6	7
Individual	5	6	59	56	22	14	5	3	11	15	2	3	1	9
Government	1	1	4	22	52	39	*	11	40	17	*	6	4	6
Finance Co.	2	2	33	29	26	32	14	10	26	27	2	*	*	2
Insurance	1	1	55	53	5	27	5	*	30	7	*	7	5	7
Factor	*	*	25	*	50	*	*	*	*	*	*	*	*	*
Co-op	1	1	12	24	56	53	8	*	16	18	4	*	*	6
S & L	2	2	21	22	27	19	32	16	6	41	3	*	12	3
Other	2	2	32	29	43	43	4	*	15	16	*	4	7	8
No Answer	1	1	57	50	24	43	5	*	*	*	5	*	5	7
All Firms	100%	100%	38%	36%	28%	29%	9%	4%	17%	20%	2%	4%	6%	7%

---

* Less than 0.5%

ERRATUM

Table 18

Short-Term Loans (under 12 months) From Commercial Banks

	1980 Survey				1982 Survey			
Rate Paid	79:2	79:3	79:4	80:1	81:2	81:3	81:4	82:1
Under 10%	9	10	1	1	9	2	3	1
10-12.9	51	48	24	8	7	10	5	1
13-15.9	21	26	44	31	7	7	5	3
16-18.9	2	12	20	41	36	34	42	57
19-20.9	2	1	3	10	6	9	11	9
21+	2	*	*	4	3	2	6	2
Prime, +1[1]	5	1	4	3	17	12	11	12
+1 to +2	3	1	2	2	15	21	14	13
+2 or more	5	1	2	*	*	3	3	2
Average Rate Paid(Percent)	12.4	12.4	14.4	16.3	16.2	17.7	17.5	17.7
No. of Cases	88	11	180	428	69	87	145	376
Average Prime Rate[2]	11.7	12.1	15.0	16.4	19.0	20.4	17.0	16.3

* Less than 0.5 percent

[1] In the 1982 survey the category "Prime + ___" was added to the interest rate question.

[2] Obtained from The Federal Reserve Bulletin.

Table 13

FORM OF COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Business Collateral					Personal Collateral				
	Total	Accounts Receivable	Inventory	Plant and Equipment	Don't Know	Total	House	Stock	Other	Don't Know
Industry:										
Construction	15%	28%	25%	44%	3%	15%	44%	6%	45%	5%
Manufacturing	14	15	12	70	3	12	40	21	37	2
Transportation	3	9	16	75	*	3	29	*	71	*
Wholesale	8	19	42	38	1	8	34	19	45	2
Retail	33	11	44	41	4	35	38	19	39	4
Agriculture	7	16	29	52	3	4	20	20	56	4
Finance	5	24	11	61	4	8	31	18	51	*
Services	9	16	13	69	2	10	41	23	34	2
Professional	5	31	7	56	6	5	28	10	59	3
No Answer	1	20	20	60	*	*	*	100	*	*
Loan Source:										
Bank	85%	18%	29%	50%	3%	85%	37%	17%	43%	3%
Individual	4	18	23	59	*	5	37	11	48	4
Government	1	17	8	67	8	1	67	17	16	*
Finance Co.	3	4	18	67	11	3	47	5	32	16
Insurance Co.	1	*	*	100	*	*	*	*	100	*
Co-op	1	18	36	36	10	1	*	25	75	*
S & L	2	17	22	56	5	3	53	16	31	*
Other	3	10	32	58	*	2	*	20	80	*
Loan Maturity:										
Short-term	42%	28%	38%	32%	2%	42%	28%	20%	49%	2%
Medium-term	33	8	20	67	5	31	37	16	44	3
Long-term	18	7	15	75	3	18	59	11	27	3
No Answer	7	24	38	33	5	9	33	19	44	4
Total	100%	18%	28%	51%	3%	100%	37%	17%	43%	3%

---

*Less than 0.5 percent

D. Lines of Credit and Compensating Balances

For frequent borrowers a business lending arrangement such as a pre-approved line of credit gives the borrower more flexibility with loan take-downs and repayments. The flexibility provided by the line of credit does not come free to the borrower, however. The lender is compensated through fees (a certain percentage of the unborrowed amount) or compensating balances (a required percentage of the total line that must be taken down and kept in a demand deposit account).

Preapproved lines of credit were reported by only 32 percent of the firms with loans outstanding (Table 14). Construction, wholesaling, and agricultural businesses most frequently reported lines of credit, while service and professional firms used lines less often (under 20 percent of the firms). Line of credit usage and the size of the line rose with borrowing frequency. This industry effect is largely due to borrowing frequency. Agriculture, wholesaling, and construction firms most often reported borrowing at least once per year. Line of credit usage and the size of the line predictably rose with firm size and loan size. Lines of credit were most frequently reported for short-term loans (40 percent) and were least prevalent for long-term financing.

Compensating balances were required on only 10 percent of the loans (Table 15). The incidence of balances was unrelated to firm size, although larger firms typically reported larger required balances. Balance requirements not surprisingly rose with loan size, since requirements are often computed on the basis of the total credit line or amount used. Loan maturity was unrelated to the use of compensating balances.

The usage of credit lines and compensating balances did vary with bank size, the degree of urbanization in the borrower's market, and branching status in the borrower's state of residence (Table 16). Lines of credit were more frequently reported in metropolitan bank markets, from banks with assets over $500 million, and in states with unit or limited branching. Neither bank size nor branching status were related to the incidence of compensating balances, but they were more frequently reported from borrowers in metropolitan areas.

E. Interest Rates

The average interest rate paid by small business borrowers is shown in Table 17 by maturity and date of origination. For all maturities, interest rates have risen substantially since 1974. Rates charged on short-term loans rose far faster than rates on long-term loans, reflecting the inverted yield structure that

Table 14

PRE-APPROVED LINES OF CREDIT BY SELECTED VARIABLES

		Credit Limit					
	None	Under $5000	$5000-24,999	$25,000-49,999	$50,000-99,999	$100,000-199,999	$200,000 or more
Industry:							
Construction	56%	3%	4%	10%	11%	7%	6%
Manufacturing	69	6	5	2	4	4	10
Transportation	69	*	10	5	3	4	9
Wholesale	59	4	5	4	7	5	16
Retail	71	4	6	5	6	3	5
Agriculture	53	4	5	7	7	8	16
Finance	73	4	2	11	5	2	3
Services	81	4	8	3	1	1	2
Professional	82	3	5	1	3	2	4
Annual Sales: (thousands $)							
under 50	82	7	6	2	1	*	2
50-99	76	6	10	4	3	1	*
100-199	74	3	9	5	5	3	1
200-349	74	2	7	7	4	2	4
350-499	67	3	6	7	8	4	5
500-799	68	4	7	6	8	4	3
800-1,499	61	3	5	7	10	7	7
1,500-2,999	51	2	2	6	10	11	18
3,000 or more	57	6	1	1	3	6	26
Loan Size:							
Under $5000	77	9	11	2	1	*	*
$5000-9999	74	5	12	6	2	*	1
$10,000-19,999	75	2	8	6	6	2	1
$20,000-39,000	67	2	4	11	7	5	4
$40,000-99,999	60	2	1	5	14	7	11
$100,000-299,999	58	6	*	*	6	11	19
$300,000 or more	54	5	1	1	2	3	34
Borrowing Frequency: (times per year)							
None	78	4	4	4	4	2	4
1	71	4	6	5	5	4	5
2	65	2	9	6	7	5	6
3 or more	48	5	6	7	10	6	18
Loan Maturity: (months)							
1-12	60	4	7	7	8	6	9
13-60	78	5	5	4	4	2	3
61 or more	82	3	2	1	4	4	5
All Firms	68%	4%	6%	5%	6%	4%	7%

---

* Less than 0.5 percent

Table 15

COMPENSATING BALANCES BY SELECTED VARIABLES

			Size of Balance			
	All Firms	Balance Requirements	Under $3000	$3000-$14,999	$15,000 $24,999	$25,000-plus
Annual Sales: (thousands $)						
under 50	7%	10%	7%	1%	2%	*
50-99	11	12	9	1	1	1
100-199	15	10	5	2	2	1
200-349	15	9	5	2	1	1
350-499	10	8	4	2	1	1
500-799	9	10	5	4	1	*
800-1,499	9	10	4	2	3	1
1,500-2,999	12	11	4	3	3	1
3,000 or more	10	12	2	1	2	7
Loan Size:						
under $5000	12	10	9	*	1	*
$5000-9999	14	9	6	2	1	1
$10,000-19,999	21	9	5	3	1	*
$20,000-39,999	18	9	5	2	1	1
$40,000-99,999	15	6	2	2	1	*
$100,000-299,999	12	12	3	3	4	2
$300,000 or more	6	17	1	2	3	11
Line of Credit						
None	68	7	4	2	1	1
Under $5,000	4	23	13	4	4	1
5,000-24,999	6	20	13	3	4	0
25,000-49,999	5	13	6	3	2	2
50,000-99,999	6	9	4	3	2	1
100,000-199,999	4	10	2	2	4	2
200,000 or more	7	18	1	3	5	9
All Firms	100%	10%	5%	2%	2%	1%

---

* Less than 0.5 percent

prevailed in the late 1970's. In the first quarter of 1980, the average short-term rate paid was 16.9 percent, 240 basis points (2.4 percentage points) above the average rate on long-term loans taken out during the same period. In April, 1982, the average rate paid on both short- and long-term loans was higher than that reported in April, 1980, although the differential between short- and long-term

Table 16

LINES OF CREDIT AND COMPENSATING BALANCES
BY SELECTED VARIABLES

	Percent With Lines of Credit	Percent With Compensating Balances
Bank Size: (Millions)		
Under 100	29%	9%
100-500	35	10
Over 500	33	10
Don't Know	19	16
Market Size:		
Rural	31	9
Small City	32	10
City	31	10
Metropolitan	37	14
State Branching Law:		
Statewide	28	8
Limited	34	11
Unit	33	11
All	32%	10%

loans had narrowed substantially. This narrowing differential was consistent with the yield curve at the time of the survey when the prime rate was at 16.50 percent, and the corporate Baa bond rate was at 13.24 percent.

The 1982 survey specifically identified those borrowers with loans tied to the prime rate. Almost 28 percent paid interest rates (on loans of all maturities) tied to the prime. The Quarterly Economic Report has also identified the proportion of short-term loans tied to the prime rate beginning in April, 1982. This proportion has ranged from 32 percent to 38 percent in the October 1982 report (Table 18). The proportion of short-term loans tied to the prime rate in the April, 1982 Credit, Banks and Small Business survey was 30 percent.

The data certainly do not support the conclusion that most small businesses borrow at rates substantially above the prime rate. Only two percent reported short-term rates greater than prime + 2 (less than one and a half percent in the 1982 *Credit, Banks and Small Business Survey*). The average rate paid on short-term loans has generally been above the prime rate. This difference has been the greatest when the prime rate was falling (81:4, 82:3) and the least (even negative) when the prime rate was rising (81:2, 80:1).

Rates paid for large loans were generally higher than those paid on small loans (Table 19), suggesting that any scale economies accrued from making the larger loan were offset by increased risk of higher leverage in the borrowing firm's portfolio. Secured loans had higher interest rates across all maturities, but the difference narrowed between 1980 and 1982. Although collateral reduces the potential foreclosure costs of the loan to the lender by giving first priority to the assets in the event of bankruptcy, a secured loan is more costly to administer than an unsecured loan. Thus,

Table 17

AVERAGE INTEREST RATES[1] PAID BY MATURITY

Date of Loan		Number of Cases	Maturity (Months) 1-12[2]	13-60	Over 60
April 1980:	1974 or earlier	114	7.6%	8.5%	7.2%
	1975	30	8.9	8.6	8.3
	1976	53	8.8	9.2	11.3
	1977	85	9.6	10.9	10.1
	1978	194	10.4	11.3	10.3
	1979 I	103	12.2	12.7	11.5
	1979 II	159	12.7	13.0	12.6
	1979 III	169	12.5	12.8	12.2
	1979 IV	274	14.4	14.0	13.2
	1980 I	620	16.4	15.2	14.0
April 1982:	1981 I	137	16.0	15.7	14.9
	1981 II	156	16.1	15.9	14.2
	1981 III	173	17.4	16.2	14.1
	1981 IV	297	17.5	16.5	14.2
	1982 I	592	17.7	17.3	16.9

---

[1] If the loan rate was tied to the prime rate, the prime rate applicable at the date of origination was used.

[2] Included revolving credit.

Table 18

INTEREST RATES PAID ON SHORT TERM LOANS
(12 Months or Less)

				#New Series[1]			
Rate Paid	81:1	81:2	81:3	81:4	#82:1	82:2	82:3
Under 13%	3%	1%	2%	2%	# 1%	1%	1%
13 - 15%	15	5	3	7	# 5	4	19
16 - 18%	46	34	30	57	# 50	52	37
19 - 22%	27	48	56	25	# 11	11	5
23% or More	1	5	3	2	# 1	*	*
Prime, +1	4	4	4	4	# 17	18	23
Prime +2	3	2	2	2	# 13	12	12
Prime +3 or More	1	1	*	1	# 2	2	3
	100%	100%	100%	100%	#100%	100%	100%
Average Rate	19.3%	17.9%	17.8%	17.6%	15.4%	14.1%	13.5%
Prime Rate at End of Quarter	18.5%	15.8%	16.5%	16.0%	12.0%	11.0%	10.5%

---

[1] Beginning in 1982, the category "prime + ____" was added to the interest rate question.

* Less than 0.5 percent

Source: Quarterly Economic Report for Small Business (National Federation of Independent Business), various editions.

while the cost reduction should reduce the contract rate on a loan, the additional administrative costs raise them. Secured loans would most likely be issued to riskier borrowers where the value of the cost reduction exceeds the increase in administrative costs. Thus, risky borrowers would most likely find the interest rate on secured loans lower than on unsecured loans, while other borrowers would find unsecured loans preferable.

Corporate borrowers typically paid higher rates than unincorporated borrowers for all loan maturities prior to early 1980. Several

Table 19

AVERAGE INTEREST RATES PAID BY LOAN AND FIRM CHARACTERISTICS

Characteristics	Short-Term 1980[1]	1982[2]	Medium-Term 1980[1]	1982[2]	Long-Term 1980[1]	1982[2]
Loan Size:						
under $5,000	14.4%	17.2%	14.3%	17.1%	--	--
$5,000-10,000	14.1	16.6	13.9	16.6	12.7	16.7
$10,000-20,000	14.4	17.3	13.8	16.2	11.7	18.1
$20,000-40,000	15.0	17.7	12.9	16.3	13.1	14.9
$40,000-99,000	15.6	18.0	14.3	17.0	12.3	13.4
$100,000-300,000	16.4	17.0	14.6	16.4	13.2	14.7
$300,000 or more	16.2	18.0	15.5	17.1	14.5	15.1
Collateral Required:						
No	14.2	17.1	13.4	16.2	12.1	13.7
Yes	15.6	17.6	14.1	16.7	13.0	15.0
Form of Business:						
Corporate	15.4	17.3	14.3	16.7	13.4	14.8
Partnership	13.7	18.2	13.9	17.0	11.0	13.4
Proprietorship	14.3	17.2	13.3	16.2	12.3	15.3
Region:						
New England	16.3	17.1	13.7	17.0	15.4	15.4
Mid Atlantic	14.7	16.1	12.8	16.7	12.0	15.3
E. N. Central	14.6	17.0	14.4	17.0	13.9	14.3
W. N. Central	14.5	17.2	13.4	15.4	11.7	14.8
South Atlantic	14.4	16.9	13.0	15.2	13.2	16.9
E. S. Central	14.6	17.6	13.4	16.8	13.0	15.4
W. S. Central	14.6	17.6	13.8	16.4	12.9	14.6
Mountain	15.4	18.7	13.9	17.7	13.4	13.7
Pacific	15.9	17.9	15.3	17.0	11.7	14.4
Bank Asset Size: ($ million)						
Under 100	14.5	17.2	13.5	16.1	12.9	15.0
100-499	15.0	17.8	13.6	16.4	13.0	14.9
500 or more	15.8	17.2	14.5	16.9	12.9	14.1
Market Size:						
Rural	14.3	17.0	13.6	16.5	12.8	14.5
Small City	15.1	17.5	13.9	16.8	13.0	14.9
City	14.2	18.0	12.9	16.3	15.9	16.4
Metropolitan	15.4	17.7	14.4	16.7	13.2	13.4
State Branching Law:						
Unit	14.8	17.3	13.6	16.6	12.9	14.8
Limited	14.7	17.2	13.7	16.3	13.0	14.8
Statewide	15.4	17.7	14.5	16.7	12.8	15.0

---

[1] Includes only those loans originated during the fourth quarter of 1979 and the first quarter of 1980.

[2] Includes only those loans originated during the fourth quarter of 1981 and the first quarter of 1982.

factors potentially contributed to this differential. First, corporate borrowers tend to be larger and more frequently take out larger loans which carried higher interest rates during the period. Second, in the event of default, liability is limited to the extent of corporate assets, while for unincorporated borrowers, the owner's personal assets as well as the assets of the business are legally available to settle the debt (subject to exemptions enumerated in state and Federal law).

The corporate/non-corporate difference in interest rates paid diminished in 1982. One likely explanation is the changed U.S. bankruptcy code, effective October 1, 1979, which expanded the amount of personal assets exempt from bankruptcy proceedings, automatically stayed efforts to recover property once a filing for bankruptcy was made, and made it easier for proprietorships with unsecured debt under $100,000 to proceed into Chapter 13 bankruptcy. These changes in the bankruptcy code may have increased uncertainty over the lender's ability to obtain personal assets, or increased the risk of default by reducing its cost to the borrower. In either case the effect would be to increase the interest rate on non-corporate loans relative to corporate loans.

Rate of business growth, region, the size of the lending bank, the size of the market (rural versus urban) and the branching laws applicable in the state were related to the average rate charged. Loan rates were consistently higher in statewide branching states, but never more than 80 basis points. Small lenders provided consistently lower rates (perhaps because they make relatively more small loans for which rates were lower than for large loans), but never more than 130 basis points. Firms in rural areas consistently reported lower loan rates. These differences could have been due to a lower cost of funds because smaller banks historically have had a lower proportion of interest sensitive deposits compared to large banks.

Between 1980 and 1982 the rural-urban, small bank-large bank, and unit-statewide differentials narrowed substantially (Table 19). The continuing effect of deregulation on the liability side of commercial bank balance sheets contributed to the narrowing interest rate differentials. Penetration of money market mutual funds into rural markets induced smaller banks to offer jumbo (over $10,000) CD's at market rates to prevent the loss of their biggest depositors. The result was higher lender costs. Further, loans tied to the prime rate occur more frequently in large banks, metropolitan banks, and banks in statewide branching states. Small firms located in these areas will, on average, find their rates rising more rapidly in periods when the prime rate is rising, e.g. April 1980. In April 1982, interest rates had stabilized and most fixed rate loans adjusted (with a lag) to these higher rates, thus narrowing the bank structure and locational differences. With the dramatic decline in the prime rate during the third quarter of 1982, it should not be surprising, then, that (1) the average short-term rates on rural loans *exceeded* metropolitan loans; and (2) the average rate on loans made in unit banking states exceeded the average rate on loans made in statewide branching states (Table 20). Thus, the ostensible bank structure effect on contract rates in the 1980 survey may be attributable to differences in the proportion of prime rate loans.

Table 20

INTEREST RATES PAID ON SHORT-TERM LOANS
(12 Months or Less)

Average Rates Paid During Quarter	1981				1982		
	I	II	III	IV	I	II	III
Bank Market:							
Rural	18.2%	18.6%	17.6%	17.6%	17.4%	17.4%	16.0%
Suburban	19.1	19.6	18.0	18.0	17.7	17.5	15.7
Metropolitan	19.7	20.1	18.1	18.1	18.1	17.7	15.1
Branching Status:							
Statewide	19.7	19.8	18.2	18.2	18.1	17.8	15.6
Limited	18.4	19.2	17.6	17.6	17.5	17.3	15.5
Unit	19.0	19.1	17.8	17.8	17.6	17.5	15.8

Source: *Quarterly Economic Report for Small Business* (National Federation of Independent Business), various editions.

III. Credit Availability and Small Business

A. Ability to Obtain Credit

Most small businesses were able to arrange the desired financing. Over 50 percent reported all of their credit needs have been met, while less than 15 percent reported that some needs or major needs had not been met (Table 21). The remainder reported most needs fulfilled. Additionally, 83 percent in both surveys reported that 90 to 100 percent of the most recent initial loan request had been granted (Table 22).

Over 70 percent reported that originally requested loan terms were received (Table 23). Although the percentage fell by two

Table 21

CREDIT EXPERIENCE BY SELECTED VARIABLES

	Credit Needs Met:							
	All		Most		Some Not		Major Not	
	80	82[1]	80	82[1]	80	82[1]	80	82[1]
Years in Business:								
1-2	44%	37%	29%	25%	12%	16%	8%	11%
3-4	47	39	27	27	15	13	9	12
5-6	40	44	37	26	11	13	7	5
7-10	50	52	32	24	9	8	4	6
11-15	55	51	28	25	10	11	3	4
16-20	59	52	26	21	9	11	3	1
21 +	68	56	19	16	6	5	2	2
No Answer	67	67	5	11	19	0	0	0
Business Activity:								
Rapidly Growing (21+%)	54	48	27	24	8	11	7	5
Growing (6-20%)	58	54	28	21	8	7	3	4
Steady (0-5%)	62	49	23	21	8	8	3	5
Decline	38	48	29	20	18	13	10	7
Too New	53	40	18	29	10	11	12	12
No Answer	19	49	19	13	10	1	4	6
Collateral Required:								
Yes	47	49	31	25	12	12	5	6
No	66	53	20	16	6	6	3	3
Banks Used:								
1	59	53	25	20	8	8	4	5
2	49	47	31	23	11	10	5	5
3 or More	53	50	25	23	13	15	6	3
Active Solicitation:								
Yes	58	58	26	20	9	8	4	3
No	54	46	26	24	11	10	5	7
Bank Size: ($ Million)								
Less than 100	58	52	25	22	9	10	4	5
100-500	54	51	27	22	11	9	5	4
Greater than 500	52	49	29	21	9	8	5	7

Table 21 (cont.)

CREDIT EXPERIENCE BY SELECTED VARIABLES

	Credit Needs Met:							
	All		Most		Some Not		Major Not	
	80	82[1]	80	82[1]	80	82[1]	80	82[1]
Community Size:								
Rural	58	51	26	21	8	10	4	5
Small City	55	52	26	21	10	9	4	5
City	52	48	27	25	12	9	5	5
Metropolitan	51	50	30	18	11	7	4	7
State Branching Law[2]								
Statewide	52	44	28	24	11	9	5	7
Limited-One Bank	55	52	26	19	10	11	4	4
Multi Bank	61	54	23	20	8	9	4	4
Unit - One Bank	63	56	23	25	6	7	5	3
Multi Bank	55	56	29	20	8	8	4	4
All Firms	56	51	26	22	10	9	4	5

---

[1] 1982 survey included a classification "does not borrow".

[2] Limited and unit branching categories are broken down by holding company classification.

points from 74 to 72 between 1980 and 1982, substantial majorities of operating firms did receive their requested loan sizes and loan terms even in the difficult period covered by the surveys. While most firms were satisfied with loan terms, satisfaction did fall between 1980 and 1982. The proportion reporting terms very satisfactory fell from 41 to 35 percent, while the proportion reporting terms not good or unsatisfactory rose from 16 to 20 percent. The interest rate on the loan was the most frequently mentioned reason for loan term dissatisfaction (Table 24). This percentage jumped from 43 percent in 1980 to 63 percent in 1982; at the same time, satisfaction with loan size and maturity fell from 10 percent to 6 percent.

This shift in reasons for dissatisfaction closely reflects the difference in credit market conditions between April, 1980, and April, 1982. In April, 1980, the Fed was rapidly contracting the money supply (-12.4% annualized change in M1 from the end of February to the end of April) and banks adjusted to this decline by shortening maturities or lowering the amounts offered. Between February and April, 1982, the seasonally adjusted money supply grew at a 7 percent annual rate. And, not suprisingly, problems with loan amounts fell. The increased proportion of firms reporting problems with the loan interest rate undoubtedly reflected the cumulative effect of an historically high debt service burden over the past three years.

Firms that did report credit availability problems (general satisfaction, percent granted, etc.) appeared to be riskier than

Table 22

CREDIT AVAILABILITY BY SELECTED VARIABLES

	Percent of Initial Loan Request Granted						Credit Availability Effect on Expansion Plans					
	90-100%		50-89%		under 50%		Yes		No		Don't Know	
	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:												
1-2	78%	75%	10%	6%	5%	11%	47%	46%	35%	37%	30%	15%
3-4	82	78	6	4	5	13	54	49	32	37	21	13
5-6	82	85	8	2	3	9	51	43	35	42	21	17
7-10	83	85	7	1	1	9	47	42	40	46	26	20
11-15	86	83	5	3	2	6	43	32	47	48	28	20
16-20	86	90	2	2	2	3	43	32	42	51	27	23
21 +	83	84	3	1	2	4	35	32	51	52	35	25
No Answer	90	61	0	0	0	11	43	17	38	56	33	22
Business Activity:												
Rapidly Growing (21%)	85	80	6	4	4	9	45	41	44	48	27	21
Growing (6-20%)	85	86	5	1	3	6	45	34	43	49	28	25
Steady (0-5%)	83	84	5	1	1	7	36	37	49	44	34	18
Decline	82	83	6	3	4	6	63	42	26	41	15	16
Too New	86	73	4	9	6	11	39	44	35	40	37	19
No Answer	56	73	3	1	3	9	22	37	47	39	44	19
Collateral Required:												
Yes	85	85	8	3	3	10	52	43	37	44	23	16
No	80	81	2	2	2	3	33	32	51	51	36	27
All Firms	83%	83%	5%	2%	3%	7%	44%	41%	43%	47%	7%	6%

Table 23

LOAN TERM SATISFACTION

	Percent of All Firms		Received Originally Requested Loan Terms						Satisfaction with Loan Terms							
			Yes		No		Terms Given		Very Satisfactory		Satisfactory		Not Too Good		Unsatisfactory	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:																
1-2	8%	6%	71%	66%	16%	15%	7%	15%	38%	32%	35%	35%	16%	23%	4%	8%
3-4	12	10	74	65	11	14	10	18	38	25	37	44	17	22	3	6
5-6	10	9	67	72	12	9	14	15	32	29	42	42	17	23	2	2
7-10	16	16	77	73	8	10	10	12	38	32	39	42	16	16	3	5
11-15	12	12	75	73	12	9	8	11	40	29	39	45	11	17	4	4
16-20	10	9	74	80	9	8	9	7	40	37	34	42	14	12	2	4
21 +	31	37	75	71	7	8	7	11	48	41	31	35	9	12	3	2
No Answer	1	1	67	56	14	0	9	17	38	33	29	17	14	22	9	6
Business Activity:																
Rapidly Growing (21%)	10	14	75	71	14	11	8	10	41	32	32	40	17	19	4	3
Growing (6-20%)	47	39	76	75	10	10	8	10	42	38	37	39	12	15	3	3
Steady (0-5%)	27	21	74	71	7	8	11	14	44	34	35	41	12	15	1	3
Decline	11	19	71	69	14	9	8	15	31	32	34	39	21	19	7	4
Too New	2	4	75	66	10	15	10	15	43	32	35	40	12	14	6	11
No Answer	3	3	49	66	6	4	6	12	26	33	25	30	8	15	3	7
Collateral Required:																
Yes	56	56	74	70	14	14	10	14	34	28	40	45	19	22	4	5
No	44	44	74	73	5	4	8	10	50	43	29	32	6	9	2	2
All Firms	100%	100%	74%	72%	10%	10%	9%	12%	41%	35%	36%	39%	13%	16%	3%	4%

Table 24

REASONS FOR LOAN TERM DISSATISFACTION
BY SELECTED VARIABLES

	Interest Rate		Amount		Maturity		Collateral		Comp. Balances		Treatment		Time		Under-stand		Other	
	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82	80	82
Years in Business:																		
1-2	42%	49%	11%	10%	11%	6%	10%	14%	0%	2%	6%	7%	7%	6%	7%	6%	6%	0%
3-4	45	54	13	9	10	5	14	12	1	4	4	5	7	5	3	5	3	1
5-6	39	60	13	4	11	7	14	14	1	1	5	4	6	6	9	5	1	0
7-10	45	63	10	7	10	3	18	12	1	3	5	4	7	3	3	3	2	2
11-15	54	69	11	5	6	6	11	10	2	0	4	3	4	2	5	5	4	0
16-20	63	76	6	0	6	5	12	8	2	4	2	1	3	5	3	1	2	0
21 +	53	67	8	4	11	9	11	9	2	3	4	2	4	3	6	2	2	1
No Answer	64	78	0	11	27	0	9	0	0	0	0	0	0	0	0	11	0	0
Business Activity																		
Rapidly Growing (21%)	42	64	11	5	9	6	14	10	1	3	2	3	8	4	8	4	5	1
Growing (6-20%)	49	62	9	6	10	4	12	12	1	4	5	3	5	3	6	5	2	1
Steady (0-5%)	50	70	10	3	11	7	12	10	1	2	4	3	6	2	4	2	2	1
Decline	51	63	12	6	9	7	14	12	2	1	3	5	4	3	3	2	2	1
Too New	48	62	8	7	16	7	4	10	0	1	4	2	4	5	8	5	8	1
No Answer	43	57	7	5	7	11	21	8	0	0	7	5	7	8	4	6	4	0
Collateral Required:																		
Yes	44	57	11	6	11	6	16	14	1	3	4	4	6	4	5	4	2	1
No	67	79	9	4	6	6	2	1	0	0	5	3	3	2	6	2	3	2
All Firms	49%	63%	10%	6%	10%	6%	13%	11%	1%	2%	4%	3%	5%	4%	5%	4%	3%	1%

average. Firms in business under 4 years or too new to assess their growth more frequently reported major credit needs not met, less than 100 percent of their initial loan request granted, not receiving their originally requested loan terms, dissatisfaction with loan terms, and reduction in expansion plans due to credit availability. Firms that reported declining sales or rapid growth and those reporting secured loans also more frequently reported less favorable credit experience than did others. Risk also appeared to be inversely related to those firms reporting the interest rate as a reason for dissatisfaction.

The effect of bank structure characteristics upon credit availability was mixed. Only the distributions for the general credit experience variable are presented in Table 21, because all of the availability questions resulted in the same general pattern of responses. Borrowers from smaller banks and banks in rural areas more frequently reported all credit needs met, although these differences narrowed in 1982. No clear pattern existed between firms reporting credit needs not met and bank size or bank market. A stronger relationship appeared between credit availability and solicitation by a bank for its business within the last five years. Firms that were solicited more frequently reported all credit needs met. The degree of branching also affected credit availability, as firms residing in states with statewide branching less frequently reported all credit needs met.

B. Loan Rejections

Over 85 percent of the firms that reported a loan attempt at a commercial bank had their most recent request accepted (Table 25). The rejection rate was 13 percent in 1980 and 11 percent in 1982. "Low equity" or "too much debt" proved common reasons for rejection, the latter doubling in frequency between 1980 and 1982. This increase mirrored the deteriorating financial condition of business in general caused by low sales and the high cost of financing working capital. "Tight money," on the other hand, fell from 27 percent to 9 percent as a reason for rejection. If credit availability had been a problem in 1980, due to controls imposed on bank asset growth as well as the rapid contraction in the money supply, it was not in 1982.

Newer firms (under 4 years in business) more frequently reported a loan rejection, reflecting the higher default risk associated with newer firms (Table 26). Declining firms most frequently reported a rejection in 1980. Rapidly growing firms were most frequently rejected in 1982, but at about the same rate as in 1980. Rejection rates decreased as borrowing frequency increased, presumably because regular borrowers are better established with their lending institutions.

Table 25

REASON FOR LOAN REFUSAL

Reason	April 1980	April 1982
Too New	13%	16%
Too Much Debt	9	18
Lender Had No Money	27	9
Use Not Wise	8	4
Couldn't Repay	1	3
Low Equity	10	14
Poor Pay History	1	3
Weak Financial Statement	11	11
No Idea (Why Loan Refused)	10	12
No Answer	10	10
Total	100%	100%
Total Attempts[1]	2012	1849
Total Rejected	254	193
Total Accepted	1709	1583
Rejection Rate	.13	.11
Acceptance Rate	.85	.86

---

[1] Included those whose decision on the loan request is pending.

Firms that used only one bank least frequently reported rejections. Those that applied to a bank other than their principal bank more frequently reported rejections. Whether that implies a rejection at the firm's principal bank first is not known. Loan applicants at branch offices also more frequently reported rejections. This pattern is consistent with firms in statewide branching states less frequently reporting acceptance of the latest loan request.

Table 26

CHARACTERISTICS OF ACCEPTED AND REJECTED FIRMS

			Last Loan Attempt					
	Total		Accepted		Rejected		Don't Know	
Characteristics	1980	1982	1980	1982	1980	1982	1980	1982
Years in Business:								
1-2	8%	6%	76%	72%	21%	22%	3%	7%
3-4	12	10	74	75	20	21	5	4
5-6	10	9	79	86	18	12	3	2
7-10	16	16	85	83	13	12	2	5
11-15	13	12	87	89	12	10	1	1
16-20	10	9	89	84	9	12	2	4
21+	30	36	92	91	7	6	2	4
No Answer	1	1	89	100	6	*	6	*
Business Activity:								
Rapidly Growing(21%+)	10	15	85	83	14	15	1	2
Growing(6-20%)	48	39	86	90	11	7	3	3
Steady(0-6%)	26	20	88	85	10	10	2	5
Declining	11	20	79	85	19	12	2	3
Too New	2	4	78	66	16	22	5	12
No Answer	2	3	61	81	29	15	9	4
Number of Times Borrowed in Year:								
Once	26	25	84	84	13	13	3	4
Twice	16	15	86	87	12	10	3	3
Three or more	24	22	88	92	10	6	2	2
No Answer	33	38	83	83	15	12	31	5
Loan Source:[1]								
Principal Bank-Hdqtr	87	58	86	90	12	7	2	3
Principal Bank-Bran		28		81		15		4
Other Bank	6	6	71	64	26	17	3	9
Use One Bank Only	3	4	90	88	3	5	7	7
No Answer	4	4	81	90	13	10	6	*
State Branching Law:								
Statewide	34	35	81	81	16	15	3	4
Limited-MBH[2]	25	27	87	86	11	10	2	4
Limited-NMBH[3]	10	10	90	88	8	9	2	3
Unit-NMBH[3]	10	8	92	92	6	6	2	2
Unit-MBH[2]	17	20	84	90	14	7	2	3
No Answer	3	*	81	71	16	14	3	14
Total	100%	100%	85%	86%	13%	11%	2%	4%

---

[1] The 1980 Survey did not separate the principal bank category into headquarters versus branch.

[2] Multi-bank holding companies permitted

[3] No multibank holding companies permitted

* Less than 0.5 percent

IV. Bank Competition for Small Firm Business

Small business generally saw competition increase in their local banking markets between the survey dates. The proportion of firms reporting that a bank actively contacted them for business within the last five years rose from 37 to 40 percent (Table 27). Furthermore, the proportion of firms noticing more bank competition for their business compared to five years ago rose from 20 to 27 percent (Table 28). This increased interest in small firm business may be for several reasons. High interest rates binding against usury ceilings in some states, as well as high mortgage rates,

Table 27

ACTUAL BANK SOLICITATION WITHIN LAST FIVE YEARS
BY SELECTED VARIABLES

	1980		1982	
	Percent of all Firms	Percent Solicited	Percent of all Firms	Percent Solicited
Number of Banks in Community:				
1	8%	22%	8%	20%
2-3	28	30	26	34
4-5	24	39	25	41
6-10	18	45	20	48
11 or more	19	49	18	49
Community Size:				
Rural	40	29	41	30
Small City	30	43	30	42
City	19	46	20	51
Metropolitan	8	47	8	55
State Branching Law:				
Statewide	34	40	37	41
Limited-MBH[1]	25	36	26	41
Limited-NMBH[2]	11	30	10	37
Unit-NMBH[2]	10	35	8	34
Unit-MBH[1]	17	40	19	40
All Firms	100%	37%	100%	40%

---

[1] Multi-bank holding companies permitted.
[2] No multi-bank holding companies permitted.
* Less than 0.5 percent.

Table 28

NOTICED A CHANGE IN BANK COMPETITION BY SELECTED VARIABLES

			Change in Competition							
	All Firms		Much More		More		Much Less		Less	
	1980	1982	1980	1982	1980	1982	1980	1982	1980	1982
Number of Banks in the Community:										
1	8%	8%	6%	3%	8%	9%	4%	6%	2%	0%
2-3	28	26	6	8	12	15	6	6	3	3
4-5	24	25	6	8	16	19	7	7	2	3
6-10	18	20	9	14	12	18	8	7	2	3
11 or more	19	18	8	14	13	20	10	5	3	2
Community Size:										
Rural	40	41	7	7	10	14	6	5	3	2
Small City	30	30	8	10	16	19	7	7	2	2
City	19	20	7	11	12	20	11	7	1	3
Metropolitan	8	8	8	22	16	15	6	7	2	2
State Branching Law:										
Statewide	34	37	8	11	12	18	8	6	1	3
Limited-MBH[1]	25	26	7	12	14	14	7	4	3	2
Limited-NMBH[2]	11	10	7	8	10	18	7	9	1	3
Unit-NMBH[2]	10	8	8	6	12	18	5	6	1	1
Unit-MBH[1]	17	19	6	9	13	16	6	7	4	3
All Firms	100%	100%	7%	10%	13%	17%	2%	3%	7%	6%

---

[1] Multi-bank holding companies permitted.
[2] No multi-bank holding companies permitted.

restricted consumer credit and mortgage lending. Furthermore, the extreme competition for large firm business, e.g. from loan production offices, may have eroded the profitability of these loans. Both situations would have stimulated an interest in the small business loans as more profitable lending activity.

Changes in bank competition did not occur evenly. Small firms located in markets with four or more banks more frequently reported an active contact as well as increased competition among banks for their business. In 1980 and 1982, less than 30 percent of the firms in markets with three banks or less reported an active contact, while almost 50 percent reported a contact in markets with 11 or more banks. The frequency of active contacts and perceived increase in competition rose with the size of the market. Only 29 percent of the firms in rural markets reported a contact, versus 47 percent in metropolitan markets in 1980 (30 versus 55 percent in 1982); 17 percent of the rural firms reported a change in competition, versus 24 percent of the metropolitan firms in 1980 (21 versus 37 percent in 1982).

Differences in branching/holding company restrictions also affected the chance of a small business noticing a change in competition in its banking market. In 1980 only 30 percent of the firms located in limited branching states (where multi-bank holding companies are not permitted) reported an active contact while 40 percent of the firms in statewide branching states or in unit banking states with multi-bank holding companies were contacted. By 1982, only firms located in states prohibiting multi-bank holding companies less frequently reported an active bank contact. The frequency of perceived change in bank competition, however, showed no strong relationship to branching/holding company status in either 1980 and 1982.

V. Small Business and Its Banking Relationships

Each firm was asked to characterize its desired banking relationship and to rate the performance of its principal bank in terms of the ten dimensions listed on Table 29. All of the characteristics, with the exception of "Offers the Cheapest Money" represent non-price dimensions of a banking relationship. Small businesses rated the importance of these ten characteristics in their desired banking relationship from 1 (very important) to 4 (not important). Next they ranked their major bank's performance on these same characteristics from 1 (good) to 4 (not good). The 1982 list of characteristics differed slightly from the 1980 list: "Easy Access to Loan Officer" was inserted in place of "Knows Your Financial Needs."

A. Rankings of Desired Characteristics

The interest rate charged on a loan was not the most important aspect in a small business-banking relationship, despite record high nominal and real rates at the time of the surveys (Table 29). "Knows You and Your Business" was most frequently ranked very important (67 percent in both surveys), followed by "Reliable Source of Credit" (55 percent). "Offers the Cheapest Money," the third most frequently noted characteristic in the desired banking relationship, was ranked very important by 50 percent of the firms. Those characteristics least frequently reported as very important to

Table 29

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP
AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation									
	Very Import/ Good		Important/ Above Average		Not Very Important/ Below Average		Not Import/ Not Good		No Answer	
Characteristics	80	82	80	82	80	82	80	82	80	82
Knows Your Business										
Desired Characteristics	67%	68%	21%	22%	3%	3%	1%	2%	8%	6%
Bank Peformance	46	46	28	29	12	13	5	5	9	7
Provides Helpful Business Suggestions										
Desired	24	21	32	33	20	24	11	13	12	9
Bank	20	18	25	27	27	28	15	17	13	11
Offers the Cheapest Money										
Desired	17	50	28	30	9	8	4	3	12	9
Bank	26	22	33	34	15	21	11	12	14	12
One Person Handles Credit Needs										
Desired	40	40	35	37	11	11	4	4	11	8
Bank	44	44	30	32	8	8	6	5	12	10
Convenient Location										
Desired	39	30	37	39	11	20	3	6	10	7
Bank	52	55	28	27	6	7	3	2	11	9
Easy Access to Loan Officer										
Desired	na	42	na	41	na	6	na	3	na	8
Bank	na	50	na	32	na	5	na	4	na	10
Reliable Source of Credit										
Desired	54	55	30	31	3	4	2	2	11	8
Bank	46	48	29	28	8	9	5	5	12	10
Knows Your Industry										
Desired	29	27	37	32	19	23	7	9	13	10
Bank	24	21	27	29	22	24	13	15	15	12

Table 29 (cont.)

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation									
	Very Import/ Good		Important/ Above Average		Not Very Important/ Below Average		Not Import/ Not Good		No Answer	
Characteristics	80	82	80	82	80	82	80	82	80	82
Ideas to Improve Bank Service										
Desired	19	17	33	34	23	26	11	12	14	11
Bank	14	15	21	23	27	26	22	24	15	13
Knows Your Financial Needs										
Desired	34	na	38	na	10	na	5	na	13	na
Bank	26	na	31	na	18	na	11	na	14	na
Wide Range of Business Services										
Desired	34	32	38	42	12	15	4	3	12	8
Bank	42	47	33	32	8	8	5	3	12	10

---

na not asked.

the desired banking relationship were "Providing Helpful Business Suggestions" and "Comes to You with Ideas for Improving Bank Services." These rankings suggest that the "consulting" aspect of the banking relationship is viewed as less important than continuity and availability of credit.

B. Ratings of Performance

Rating of bank performance differed markedly from the ratings of desired characteristics in a banking relationship. Banks most frequently received good ratings on accessibility ("Convenient Location" and "Easy Access to a Loan Officer"). "Reliable Source of Credit," "One Person Handles Credit Needs," "Knows You and Your Business," and "Offers a Wide Range of Banking Services" also received good performance ratings, although significantly lower than accessibility.[4] The two characteristics least frequently rated as very important to the banking relationship ("Provides Helpful Business Suggestions" and "Offers Ideas to Improve Bank Service") were also least frequently rated "good" on performance.

Performance was also analyzed by community size (urban versus rural locations) and by branching restrictions (statewide versus unit) to investigate the claim that more liberalized branching/holding company restrictions result in better service to the banking customer.[5] Many independent bankers (especially those in rural areas) feel threatened by further deregulation because of their perceived inability to compete with larger banks that may enter their market with new branches or purchases of existing banks. Bankers in unit banking states may also see a potential threat to their markets from large banks in statewide branching states. While these data do not address all the issues involved in the debate over the effect of further bank deregulation on the quality of bank service offerings, they do provide some insight into which market structures currently provide small businesses with better performance. The data are presented in Tables 30 and 31 in two ways. The first uses the "good" performance ratings, while the second uses the "good" plus "above average" ratings.

In both surveys, rural banks more frequently received good performance ratings (relative to banks in urban areas) on almost everyone of the characteristics.[6] This superior performance was only statistically significant for "Knows You and Your Business" and "Reliable Source of Credit," using the "good" ratings. For the good plus above average ratings, "One Person Handles Credit Needs," "Knows My Industry" and "Knows My Financial Needs" were significantly higher for rural banks. The persistence of the urban-rural differences in performance is consistent with the generally accepted notion that rural banks have closer relationships with their customers. These urban-rural peformance differentials were not attributable to differences in desired characteristics in the banking relationship or individual characteristics of the respondents to the survey.

In the 1980 and 1982 survey, firms located in unit branching states rated their bank's performance significantly better than firms in statewide branching states (using the good ratings) for "Knows You and Your Business," "One Person Handles Credit Needs" and "Reliable Source of Credit." The good plus above average ratings provided mixed results. In 1980, banks in unit branching states were rated significantly better performers for all of the characteristics except "One Person Handles Credit Needs," "Convenient Location" and "Offers a Wide Range of Banking Services." By 1982, however, unit banks performed significantly

Table 30

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size							
	Rural[1]		Small City[2]		City[3]		Metropolitan[4]	
Characteristics	80	82	80	82	80	82	80	82
Knows You and Your Business								
Good	51	41	49	45	38	37	41	44
Good + Above Average	77	79	76	74	70	69	73	74
Provides Helpful Business Suggestions								
Good	23	20	21	17	16	15	17	17
Good + Above Average	48	45	45	45	38	42	46	45
Offers the "Cheapest Money"								
Good	29	23	27	22	22	21	23	19
Good + Above Average	60	54	62	57	57	58	62	56
One Person Handles Credit Needs								
Good	45	46	44	44	42	42	47	45
Good + Above Average	76	79	76	75	71	73	76	77
Convenient Location								
Good	56	59	51	54	51	54	49	46
Good + Above Average	81	86	82	84	79	80	79	74
Easy Access to Loan Officer								
Good	na	52	na	48	na	49	na	52
Good + Above Average	na	83	na	81	na	81	na	85
Reliable Source of Credit								
Good	51	52	46	47	42	45	43	44
Good + Above Average	77	78	77	76	74	74	76	77
Knows Your Industry								
Good	28	24	23	20	19	17	17	17
Good + Above Average	55	53	52	48	44	46	49	52
Ideas to Improve Service								
Good	15	16	16	13	10	13	13	15
Good + Above Average	37	37	36	36	32	40	35	38

Table 30 (cont.)

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size							
	Rural[1]		Small City[2]		City[3]		Metro-politan[4]	
Characteristics	80	82	80	82	80	82	80	82
Knows Your Financial Needs								
Good	29	na	26	na	21	na	25	na
Good + Above Average	61	na	58	na	52	na	57	na
Offers Wide Range of Banking Services								
Good	42	50	45	46	43	46	42	46
Good + Above Average	74	79	78	83	78	79	79	77

---

[1] Up to 15,000 population
[2] 15,000 to 100,000 population
[3] 100,000 to 1,000,000 population
[4] Over 1,000,000 population
na not asked.

better on only four characteristics ("Offers Cheapest Money," "One Person Handles Credit Needs," "Easy Access to Loan Officer" and "Reliable Source of Credit").

One explanation for the relative improvement in the performance ratings of banks in statewide branching states is related to the average interest rate differential on loans made in statewide and unit branching states. In the 1980 survey, firms with lower contract rates rated bank performance higher. In that survey firms in statewide branching states paid higher contract rates of interest than those firms located in unit branching states contributing to the poorer performance ratings. The decline of the unit-statewide interest rate differential in 1982, not surprisingly, was accompanied by a relative improvement in statewide bank performance ratings. Still, the statewide-unit performance differences persisted across both surveys and again were not attributable to differences in the desired banking relationship or the characteristics of the respondents. The data in Table 31 thus suggest that more liberalized branching laws are not likely to bring "improved" service to small business borrowers; in fact, they imply just the opposite.

Table 31

MAJOR BANK PERFORMANCE BY BRANCHING LAWS

	Branching Laws					
	Unit[1]		Limited[2]		Statewide	
Characteristics	80	82	80	82	80	82
Knows You and Your Business						
Good	50%	49%	47%	47%	42%	42%
Good + Above Average	80	77	74	74	70	73
Provides Helpful Business Suggestions						
Good	24	19	20	18	17	16
Good + Above Average	49	47	45	43	40	43
Offers the "Cheapest Money"						
Good	28	25	25	23	24	18
Good + Above Average	64	61	61	56	54	52
One Person Handles Credit Needs						
Good	48	50	43	42	41	42
Good + Above Average	72	80	73	76	68	73
Convenient Location						
Good	53	54	54	57	51	54
Good + Above Average	81	83	81	84	78	81
Easy Access to Loan Officer						
Good	na	52	na	49	na	49
Good + Above Average	na	85	na	81	na	79
Reliable Source of Credit						
Good	50	53	47	49	42	44
Good + Above Average	80	81	76	76	71	72
Knows Your Industry						
Good	26	24	24	20	21	19
Good + Above Average	57	53	51	49	47	48
Ideas to Improve Service						
Good	16	15	13	16	13	13
Good + Above Average	40	39	35	36	32	37

Table 31 (cont.)

MAJOR BANK PERFORMANCE BY BRANCHING LAWS

Characteristics	Branching Laws Unit[1] 80	 82	 Limited[2] 80	 82	 Statewide 80	 82
Knows Your Financial Needs						
Good	29	na	26	na	23	na
Good + Above Average	66	na	56	na	51	na
Offers Wide Range of Banking Services						
Good	43	49	44	47	41	46
Good + Above Average	78	80	75	79	74	79

---

[1] Includes both limited and statewide holding companies.
na not asked.

C. Performance Relative to Desired Ratings

The data in Table 32 provide direct comparisons of what is viewed as important in banking relationships and how major banks performed on these characteristics. A more interesting criterion for performance evaluation is to compare the actual ratings to the desired ratings to obtain a measure of relative performance. By subtracting the desired rating percentage from the actual performance percentage, this relative performance measure can be interpreted as follows: if the difference is less than zero, bank performance falls short of what small business desires; if greater than zero, performance exceeds what was desired. These data, presented in Table 32, are presented like the data in Tables 30 and 31. The first column uses the best ratings for both desired characteristics and performance. In the second column, all of the favorable ratings are used, i.e. very important plus important for desired characteristics and good plus above average for performance.

The data in Table 29 for all respondents show that banks performed best relative to the desired (using the best ratings) on "One Person Handles Credit Needs," "Convenient Location," "Access to Loan Officer," and "Offers a Wide Range of Banking Services." Banks did worst on "Knows You and Your Business," "Offers the Cheapest

Table 32

DESIRED-ACTUAL PERFORMANCE DIFFERENCES

Characteristics	Very Important/ Good		Very Important & Important/Good & Above Average	
	80	82	80	82
Knows You and Your Business	-21[1]	-22	-14	-15
Provides Helpful Business Suggestions	-4	-3	-11	-9
Offers the Cheapest Money	-21	-18	-16	-24
One Person Handles Credit Needs	4	4	-1	-1
Convenient Location	13	25	4	13
Easy Access to Loan Officer	na	8	na	-1
Reliable Source of Credit	-8	-7	-9	-10
Knows Your Industry	-5	-6	-10	-9
Ideas to Improve Service	-5	-2	-17	-13
Knows Your Financial Needs	-8	na	-15	na
Wide Range of Banking Services	8	15	0	0

---

[1] In percentage points.
na not asked.

Money," and "Reliable Source of Credit," and all of these differences were significant. With the exception of "Provides Helpful Business Suggestions" and "Comes to You with Ideas to Improve Bank Service" in 1982, all of the performance proportions differed significantly from the desired proportions. Similar patterns were observed when the sample was broken down by community size and branching laws.

The average ratings gave slightly different results. Banks performed significantly better than desired only on "Convenient Location," with no significant difference on "Comes to You With Ideas to Improve Bank Service," "One Person Handles Credit Needs" or "Easy Access to Loan Officer." Thus the differences between those rating a characteristic as "important" and rating bank performance as "above average" were of sufficient magnitude to reduce the relative satisfaction with bank performance on these characteristics.

The relatively poor performance of banks on offering the cheapest money available is not surprising considering the high interest rates at the time of the surveys. The good performance of banks having one person handle credit needs but poor performance on knowing the firm's business is puzzling. Perhaps the lending officer has multi-product responsibilities (e.g. small business, consumer credit), and the small business borrower feels that not enough time is devoted to his or her needs. Or the small business sees a frequent turnover of lending offices and is frustrated by the continual "re-learning" process required by the new officer. Banks have performed well in providing non-personal dimensions of the desired banking relationship, e.g. location and service offerings, even though most small business borrowers did not rank these characteristics as most important in their desired banking relationship.

VI. The Economic Performance of Small Business Borrowers and Non-Borrowers

Small business economic performance deteriorated in late 1979 and early 1980 as both high interest rates and a weak economy reduced employment, capital expenditures and earnings. Comparing the 1980-1982 period with 1976-1979 (See Table 33), the average net percentage of firms reporting earnings increases fell 16 percentage points; the net percentage reporting dollar increase in sales volume fell 18 percentage points; and net reported employment gains fell 10

Table 33

BORROWER/NON-BORROWER PERFORMANCE[1]

	All Firms	Borrower	Non-Borrower	Difference
Net Earnings Change During Last 3 mos. (% higher minus % lower):				
April 1976 to January 1980	- 16%	- 17%	- 15%	- 2%
April 1980 to April 1982	- 32	- 38	- 27	- 11
Sales Volume Change During Last 3 mos. (% higher minus % lower):				
April 1976 to January 1980	16	17	16	1
April 1980 to April 1982	- 2	- 5	- 2	- 3
Index of Reported Price Increases:[2]				
April 1976 to January 1980	2.91	3.16	2.62	0.54
April 1980 to April 1982	2.51	2.60	2.46	0.14
Actual Capital Expenditures During Last 3 mos. (% yes minus % no):				
April 1976 to January 1980	25	35	14	21
April 1980 to April 1982	10	15	7	8
Employee Change During Last 3 mos. (% increase minus % decrease):				
April 1976 to January 1980	5	5	3	2
April 1980 to April 1982	- 5	- 8	- 4	- 4
Current Job Openings (% yes minus % no):				
April 1976 to January 1980	- 52	- 44	- 59	15
April 1980 to April 1982	- 70	- 68	- 72	4

---

[1] Borrowers include those firms who reported borrowing regularly, i.e. at least once every three months.

[2] The Index of Reported Price Increases is a weighted average based on the responses to the survey question as to how much higher selling prices are now compared to three months ago. The 2.91 for all firms means that the average quarterly price increase was 2.91 percent.

percentage points. Borrowers and non-borrowers, however, did not share this poor performance equally. Borrowing firms[7] suffered a greater decline in earnings, capital expenditures, and employment than did non-borrowing firms. This phenomenon was produced by a massive shift in the nature of borrowing--a shift from investment-growth borrowing to cash flow-survival borrowing.

The net percent reporting higher net earnings varied little between borrowers and non-borrowers from 1976 through 1979, with non-borrowers averaging two percentage points higher than borrowers. After early 1980, however, non-borrowers reported net earnings changes averaging 11 percentage points higher than borrowers. Borrowers could have improved their net earnings relative to non-borrowers through increased sales or higher prices, as in the pre-1980 period, but sluggish demand closed both avenues. The percent of borrowers reporting a net increase in the dollar volume of sales from the previous quarter was slightly above non-borrowers from 1976 through 1980, but fell below non-borrowers from 1980 to the present. This was due in part to the fact that construction and manufacturing, both heavily dependent on borrowing, were severely affected by the recession. Although borrowers generally reported higher price increases than non-borrowers throughout the 1970s, this difference narrowed after 1980 to the point where non-borrower price increases were greater than borrower increases in 1982.[8] Faced with high inventory carrying costs and slow sales, borrowers have been forced to forego price increases in order to sell inventory and reduce a major fixed cost--interest expense.

Continued high interest rates also caused borrowers to reduce their capital expenditures. From April, 1979, through July, 1980, the net percent of borrowers reporting capital expenditures exceeded that of non-borrowers by 20 percentage points. After 1980, the average borrower/non-borrower difference fell to seven percentage points.

Employment gains by borrowers also fell relative to non-borrowers. Until mid-1979, borrowing small businesses consistently reported greater net employment gains. The net percentage adding employees averaged 5 percent for borrowers and 3 percent for non-borrowers. Since mid-1979, both borrowers and non-borrowers reported net losses in employment, but non-borrower losses have been less than those of borrowers. Borrowers averaged a net decrease of 8 percentage points, versus 4 percentage points for non-borrowers. Only during the second quarter of the brief expansion of 1981 did net employment gains from borrowers exceed those of non-borrowers. Because employment is a major variable cost under the control of the small firm, larger cuts by firms burdened with heavy interest obligations were not surprising. Firms even anecdotically reported terminating employees to raise cash in order to meet interest obligations.

C. Summary and Conclusions

Small business historically has relied heavily on the entrepreneurs's capital for its initial financing. New firms are risky and usually very small in scale. This high risk has limited the role of institutional investors, such as banks, in financing small business starts, although the importance of bank loans has grown over time. Once the firm is established, bank lending provided most of the financing for established firms. The role of government financing was inconsequential in comparison. Lenders such as credit unions, savings and loan companies and other savings institutions played minor roles in the financing of small business in the past. Their roles may increase in importance because of the new lending powers granted to these institutions by the Depository Institutions Deregulation and Monetary Control Act of 1980. The additional lending that these other depository institutions provide to small business most likely will be limited until these institutions gain expertise in the business loan market. Thus for the near future, banks can be expected to continue serving as the major source of capital to the small business community.

Almost all firms borrow money at some time during their existence. Over half borrow at least once a year, primarily from a bank. Small businesses on average are quite satisfied with their relationship with the banking community. More than half indicated that their credit needs were satisfactorily met, while at the other extreme, only 15% indicated that some needs or major needs were not met. This result is surprising for 1980 and 1982, periods of great turmoil and uncertainty in the capital markets. Over 80% of all firms reported than 90%-100% of their credit needs were met, while less than 10% reported getting less than half of their original loan request. In many instances, banks may have provided financial advice to applicant firms to assist them in determining that less money could be borrowed, helping these small firms to keep interest cost and leverage down. Over 70% reported that their originally requested loan terms were met, and less than 20% of the borrowing firms characterized the terms received as "not good" or "unsatisfactory." If this characterizes the experience of small firms during such difficult times, their collective borrowing experiences during "normal" periods are probably quite satisfactory.

The frequency of loan rejections, loan size reductions, and less than satisfactory terms suggests that there is at least the potential for improvement in the service provided by the banking community to small business. This does not mean some firms should not have difficulty getting credit, or that firms should not be refused, or granted less in volume or terms than they might like. A competitive market must produce these kinds of decisions. Rather, the issue is whether or not observed levels of difficulties are the lowest that could be produced in the market. Most economists believe that these problems will be minimized (in the absence of any subsidies) by a competitive financial market. But just what constitutes a competitive market is less clear. An increased number of competitors is generally thought to induce a greater degree of competition. This conclusion has led many observers, supported by some empirical research,[9] to argue that statewide bank branching laws are the most favorable to the development of competition and to the exploitation of any scale economies that might exist. However, banks operating under unit or limited branching laws can still be quite competitive in a local, geographically compact financial market. And statewide branching may lead to increased concentration through holding company acquisitions rather than increased numbers of competitors.

This study provided no evidence that firms were better served in statewide branching states than under any other form of branching regulation. The data suggested that, by 1982, small businesses fared no better under statewide branching regulations than they did under unit banking regulations. Active solicitation of firm business by banks increased with the number of banks in the community, which the competitive model based on numbers of firms would predict. The policy question, then, may be which form of branching rule produces the largest number of independent competitors. A good case can be made for unit banking. Statewide holding companies seem more likely to acquire independent existing banks than to open new branches. Perhaps more liberalized branching laws are justified by the value of scale economies that can be exploited by larger banks, ultimately resulting in cheaper bank services, but the data in this study do not provide evidence strongly supporting this contention.

The notion that small firms always pay more than the prime rate for their credit is also clearly incorrect. Although about one-third of all short-term loans are tied to the prime rate, most are at or below prime or no more than one point above. Many loans are obtained at rates substantially below the prime rate prevailing at the time the loan was made. The prime rate has become a very political rate in recent years. Banks have also been reluctant to change the rate in response to the volatility in the financial markets. Consequently, many loans have been made at "less than prime," but certainly at competitive rates. The argument that small firms are "riskier" and must therefore pay more for their credit may be true on average (since many small firms are very new), but cannot be true for many well established small companies that are well known and respected in their local financial markets. Thus one would expect, as this study found, that the variation in rates paid is very large compared to what one would expect to find among larger, well established firms. Even for these largest firms, the market exacts significant risk premiums for borrowing when the firm is not on a sound financial footing.

Ratings of major bank performance on these desired characteristics showed marked differences from desired ratings. Banks were rated highest in providing accessability (locational convenience and access to a loan officer), followed by reliability as a source of credit, one person handling credit, knowledge of the business, and a wide range of service offerings. Comparing the actual ratings to the desired ratings for each characteristic, banks did best in offering locational convenience and a wide range of service offerings. In the opinion of small business, banks did best in providing the non-personal characteristics desired in a banking relationship, but have room for improvement on the dimensions involving personal contact.

With an increasing number of the larger firms in this economy turning directly to the capital markets to arrange their own financing, the small business market will likely grow in importance to the banking community. The smaller firms in the economy experience, on average, the most rapid growth. In an environment where survival borrowing does not dominate credit market transactions, the small business sector may generate a large share of bank lending business. With new competition from lenders previously excluded from participation in the small business loan market, the numbers of institutions competing for the small firm's business should increase, improving the service rendered to them by the financial community.

FOOTNOTES

1/ Legler, John B. and Frank Hoy, Building a Comprehensive Data Base on the Role of Small Business in the U.S. Economy, Heller Institute for Small Business Policy Papers, 1982.

2/ See A. S. McCall, "The Impact of Bank Structure on Bank Service to Local Communities," Journal of Bank Research 11 (Summer 1980): 101-109, for a review of these studies.

3/ How Small Businesses Begin (November 1979); National Federation of Independent Business.

4/ Significance is used here in a statistical sense. Because the surveys reflect responses from only a small sample of the small business population, the "true" population response may differ from those reported in the tables presented in this paper. This deviation of the sample proportions from the true proportion is referred to as "sampling variability." For example, it can be shown that for "Reliable Source of Credit" in Table 1, the true population proportion for very important ratings will be included in the interval 55%, plus or minus 2%, 95 percent of the time; likewise, 50%, plus or minus 2%, includes the true proportion for "Offers the Cheapest Money" 95 percent of the time. These proportions significantly differ because these intervals do not overlap. If the proportion for very important ratings for "Offers the Cheapest Money" was 53 percent, then it would not differ significantly from "Reliable Source of Credit." Also, the fewer the observations for any given rating category, the wider the interval around the sample proportion.

5/ See Footnote 2 for a reference to this literature.

6/ With so few observations available for the "metropolitan" category (198 in 1980 and 180 in 1982), the sample proportions are subject to a great degree of sampling variability (i.e., wide confidence intervals). In most cases the "metropolitan" proportion is not significantly different from the "city" proportion.

7/ Borrowers are firms reporting that they borrow regularly, i.e. at least once every three months. Non-borrowers could thus include some infrequent borrowers.

8/ The index of reported price increases for January and April 1982 was:

	January	April
Borrowers	1.59	1.30
Non-Borrowers	1.64	1.55

9/ See Footnote 2.

NFIB® National Federation of Independent Business
Research and Education Foundation
150 West 20th Avenue, San Mateo, California 94403

Non-Profit Org.
Bulk Rate
U.S. Postage Paid
NFIB
Research and
Education
Foundation

NFIB®
NATIONAL FEDERATION OF INDEPENDENT BUSINESS
RESEARCH & EDUCATION FOUNDATION
Capital Gallery East, Suite #695, 600 Maryland Ave., S.W., Washington, D.C. 20024
or
150 West Twentieth Avenue, San Mateo, CA 94403

NFIB® QUARTERLY ECONOMIC REPORT FOR SMALL BUSINESS

JULY 1983

NFIB® RESEARCH AND EDUCATION FOUNDATION

AVAILABILITY OF THE QUARTERLY DATA ON COMPUTER TAPE: The entire series of the **NFIB Quarterly Economic Report for Small Business** is now available on computer tape. Tapes can be rented or special runs made by contacting Joseph Fee, President, Faculty Associates, Inc., 8979 Colony Drive, Box 181, Redwood Valley, CA 95470, (707) 485-0946.

NFIB®

NFIB QUARTERLY ECONOMIC REPORT FOR SMALL BUSINESS
(Report No. 40)

The fortieth in a series of quarterly economic reports based on survey data obtained during July, 1983, by questionnaire from member firms of the National Federation of Independent Business, San Mateo, California.

TABLE OF CONTENTS

Page

Summary of Results 1
- Earnings Trends 2
- Sales Trends. 3
- Inventories 7
- Prices Charged. 10
- Employment. 13
- Capital Expenditures. 16
- Credit Conditions 18
- Accounts Receivable 21
- Optimism. 22
- Optimism Index. 25
- Single Most Important Problem 25

Appendix A - Distribution of Respondents 29
Appendix B - Survey Questionnaire. 30

SUMMARY OF RESULTS

William C. Dunkelberg
Purdue University

Jonathan A. Scott
Southern Methodist University

William J. Dennis, Jr.
National Federation of Independent Business

The second quarter was the best quarter small business has had in five years. Real GNP grew at an annualized rate of 8.7%, but differing from such periods as the first quarter of 1981 when a 9.0% annualized rate was recorded, small business clearly shared the quarter's surge. In fact, despite the much heralded good news from the auto makers, the second quarter was arguably the "small business quarter." Soft spots were reported, but there was an overall buoyancy which carried into expectations for the third quarter. Small business owners foresaw the third quarter in nearly the same terms as it had accurately foreseen the second.

Second quarter news was positive virtually across the board, however, earnings and sales were the highlights. The Earnings Index reached a series peak--a clear reflection of improved sales and vigorous cost-cutting; the Sales Index moved sharply higher. Inventories began to be replenished, but not as rapidly as small business owners desired. Even employment scored a marked gain. For the first time since 1979, operating small businesses added employees on a seasonally adjusted basis. Average selling prices remained stable. The percentage reporting capital expenditures edged higher, even if the average size of investments edged lower. The only real "hold-out" from the good news was interest rates. While rates fell 30 basis points on average, the spread between small business rates and the prime was historically high and showed little sign of narrowing.

The third quarter was expected to be another very good quarter. The Index of Small Business Optimism (seasonally adjusted) reached a new peak, narrowly passing the previous high recorded just three months earlier. The prevailing attitude was almost exuberant. A large majority believed the economy would continue to improve and the percentage believing the present a good time for expansion was near a record high. Sales were expected to remain strong, and while some inventory accumulations occurred in the second quarter, further additions to inventory were anticipated. A second consecutive net gain in employment was projected, however, the anticipated run-up will not match that of comparable quarters in the 70's. But capital expenditure plans continued to float. Somewhat surprisingly, concern over the possibility of higher interest rates was not as prevalent as might have been expected.

This is the 40th Quarterly Economic Report for Small Business; October will mark the survey's 10th anniversary. The good news provided by the small businessmen and women in July made a very pleasant way to round out a decade. The second decade should be ushered in as appropriately.

Earnings

The Index of Small Business Earnings (seasonally adjusted) continued its dramatic improvement during the second quarter and reached a series peak (Chart 1). In July, the Index stood almost 50% above that registered in January and 75% above the recession lows recorded in the fourth quarter of 1981 and the first quarter of 1982. A survey high 28% reported increased earnings from those of the prior quarter (Table 1).

Chart 1

INDICES OF SMALL BUSINESS SALES AND EARNINGS

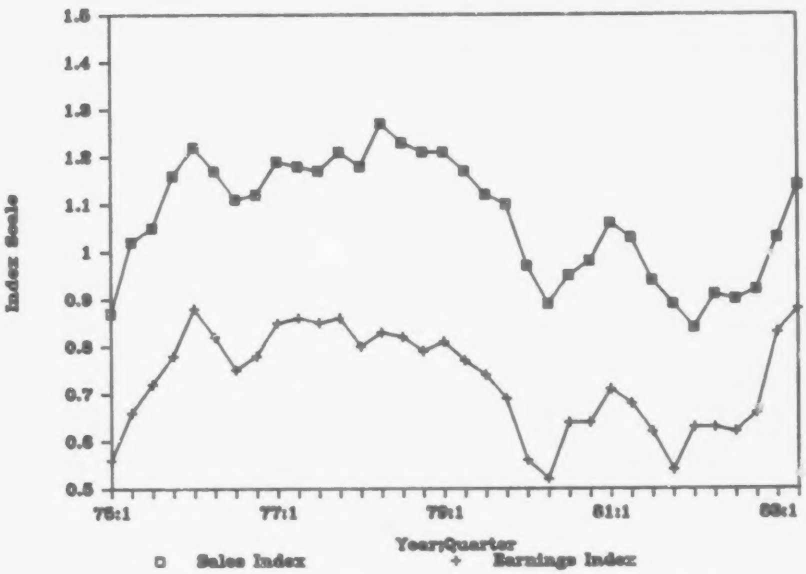


Table 1

NET EARNINGS COMPARED TO PRIOR
QUARTER'S NET EARNINGS

NET	1980	1981	1982		1983		
EARNINGS	JUL	JUL	JUL	OCT	JAN	APR	JUL
Much Higher	1	1	1	1	1	2	3
Higher	15	19	18	15	16	17	25
Same	33	39	36	38	39	38	41
Lower	41	35	36	37	33	32	25
Much Lower	9	5	7	8	9	8	4
No Answer	1	1	2	1	2	3	2
Total	100%	100%	100%	100%	100%	100%	100%

Increased sales was the most important reason provided by a healthy majority (78%) of those reporting higher earnings (Chart 2). However, in reviewing Chart 1, it is obvious that the Earnings Index has risen far more rapidly than the Sales Index. There is a reason for the different rates of change. Most small firms which survived the recession-plagued early 80's are now very lean. They have few "extra's." Any sales improvement, therefore, means an almost instantaneous increase in earnings.

The Index's rise was not attributable to any industry group(s)--a somewhat surprising development given the resurgence of the home-building (construction) industry. The same was not true among small businesses located in different regions of the country, however. The southeast, stretching south of a line from northern Virginia to the southwest tip of Kentucky and New England, were recovering more rapidly than the rest of the country. And in a switch, the West South Central region, i.e. Texas, Oklahoma, Arkansas, and Louisiana, appeared to be making the slowest recovery.

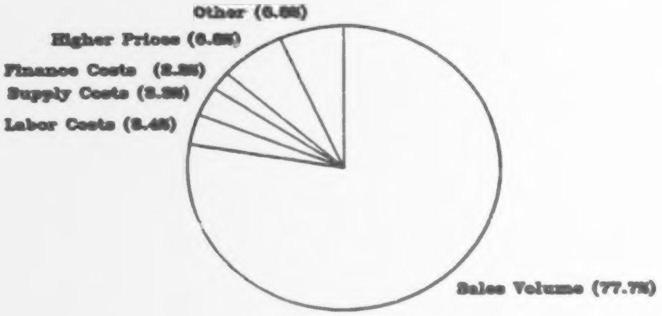
The importance of the earnings improvement is difficult to overstate. Without adequate earnings, small businesses obviously cannot invest and employ--two areas of small business weakness recently. But earnings are important in other ways as well. They reduce borrowing requirements, in effect shedding a high fixed cost and freeing capital for expansionary rather than survival purposes; and they provide the small entrepreneur an incentive to continue--an incentive badly in need of rekindling after a prolonged period of poor earnings and economic problems.

Sales

The Index of Small Business Sales (seasonally adjusted) rose for the fourth consecutive quarter, and in July stood 35% above the

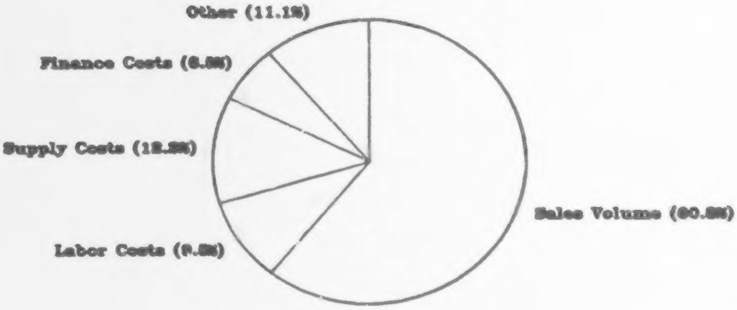
Chart 2

REASONS FOR EARNINGS CHANGES*



Higher Earnings

Lower Earnings



* "Usual Seasonal Change" and "No Answer" were factored out.

recession low recorded in April, 1982 (Chart 1). The second quarter rise was clearly the largest of the four. Forty-two percent reported higher sales in the second quarter than in the first, and while sales improvement is generally to be expected at that time of year, it is the best July reported since 1979 (Table 2). Despite the sales improvement, however, there remained soft spots, as was evidenced by the nearly one-fifth of respondents citing "Poor Sales" as their single most important problem (Table 25).

Table 2

DOLLAR SALES VOLUME COMPARED TO PRIOR QUARTER'S DOLLAR SALES VOLUME

DOLLAR	1980	1981	1982		1983		
SALES VOLUME	JUL	JUL	JUL	OCT	JAN	APR	JUL
Much Higher	3	3	2	3	3	3	5
Higher	29	32	28	24	23	26	37
About the Same	36	39	39	40	39	37	37
Lower	24	21	23	27	28	26	17
Much Lower	6	3	6	5	6	7	3
No Answer	2	2	2	1	1	1	1
Total	100%	100%	100%	100%	100%	100%	100%

The Index of Small Business Sales would indicate that the first two quarters of recovery from the most recent recession were similar to that registered during in 1975. In both instances, the index rose between 20% and 25%. The rise continued for the following two quarters in 1975-1976 and added another 15 percentage points of increase. It remains to be seen whether the similarity in the two periods will remain over the next two quarters. But small businessmen and women are clearly optimistic on that score.

Fifty-nine percent expected real volume sales to increase in the third quarter (Table 3). That is only 4 percentage points below the April level before seasonal adjustment and the highest July reading in the survey's ten-year history. The prior high (52%) was reached in both 1976 and 1977.

Optimistic expectations for real sales increases was shared by small business owners in virtually every industry (Table 4). The same was not true on a regional basis, however (Table 5). While a large majority in every region expected real sales volume increases in the third quarter, the highest expectations were in the southeast and Pacific coast areas, and the lowest expectations were in the mid-Atlantic states.

Table 3

REAL SALES EXPECTATIONS FOR NEXT QUARTER

EXPECTED REAL SALES	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Go Up a Lot	6	6	4	5	5	11	6
Go Up a Little	35	39	35	33	39	52	53
Stay the Same	27	30	32	25	26	22	24
Go Down a Little	24	17	19	23	20	8	10
Go Down a Lot	5	3	4	8	5	3	2
Don't Know	3	4	5	5	5	4	3
No Answer	*	1	1	1	*	*	2
Total	100%	100%	100%	100%	100%	100%	100%

*Less than 0.5%

Table 4

REAL SALES EXPECTATIONS FOR NEXT QUARTER BY INDUSTRY

EXPECTED REAL SALES	Con	Mfg	Tran	Whsle	Ret	Agr	Fin	Serv	Prof
Go Up a Lot	8	10	2	6	5	5	7	10	2
Go Up a Little	51	56	49	54	54	32	60	47	57
Stay The Same	26	21	16	23	26	20	20	28	28
Go Down a Little	9	7	16	14	11	24	9	8	9
Go Down a Lot	3	1	2	3	1	11	*	2	1
Don't Know	2	4	7	*	3	7	2	4	1
No Answer	1	1	8	*	*	1	2	1	2
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number	240	294	55	189	670	100	169	266	146

* Less than 0.5%

Table 5

REAL SALES EXPECTATIONS FOR NEXT QUARTER BY REGION

EXPECTED REAL SALES	New Eng	Mid Atl	EN Cent	WN Cent	So Atl	ES Cent	WS Cent	Mnt	Pac
Go Up a Lot	6	4	6	5	6	7	6	11	7
Go Up a Little	54	44	50	49	58	60	55	48	59
Stay the Same	27	27	27	29	21	19	22	24	22
Go Down a Little	9	13	12	11	9	10	11	14	6
Go Down A Lot	2	4	1	2	2	1	2	2	2
Don't Know	2	8	3	2	3	3	3	1	2
No Answer	*	*	1	2	1	*	1	*	2
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Numbers	87	220	361	306	244	100	244	195	374

* Less than 0.5%

Inventories

Small business planned to build inventories in the second quarter. But their plans were pleasantly frustrated by higher-than-expected sales. The result was an increase in inventories held, but no net reduction in the percentage of firms desiring additions.

Between April and July, the inventory position of small business changed significantly. Since advent of the inventory change series in early 1982, every survey noted that net inventories (the percentage increasing minus the percentage decreasing) had fallen from the previous quarter. In January, a net 15% reported experiencing decumulations the prior three months; one quarter later decumulations were still being experienced, but only by a net four percent; by July, a net four percent reported accumulations (Table 6). The trend in shedding inventories had been reversed.

Still, current inventory satisfaction was at one of its highest levels since institution of the survey. Eleven percent felt inventories were too low and 11% felt them too high, the latter figure being within one percentage point of a survey record (Table 7). The net zero percent represents no change from April.

Table 6

INVENTORY CHANGE IN PRIOR QUARTER

INVENTORY	1980	1981	1982		1983		
CHANGE	JUL	JUL	JUL	OCT	JAN	APR	JUL
Increase			15	14	13	19	21
Same			39	42	40	40	41
Decrease	N.A.	N.A.	26	27	28	23	17
Not Applicable			17	16	18	15	17
No Answer			3	1	1	3	4
Total			100%	100%	100%	100%	100%

N.A. Not available

Table 7

CURRENT INVENTORY LEVEL

INVENTORY	1980	1981	1982		1983		
LEVEL	JUL	JUL	JUL	OCT	JAN	APR	JUL
Too Large	16	15	15	14	13	12	11
About Right	55	55	55	56	55	56	56
Too Low	9	10	9	11	11	12	11
Not Applicable	17	16	17	16	16	15	17
No Answer	3	3	4	3	5	5	5
Total	100%	100%	100%	100%	100%	100%	100%

Inventory plans for the third quarter reflected small business expectations for sales growth as well as another attempt to increase net inventories. Eighteen percent reported plans to increase inventory and 11% reported plans to decrease them (Table 8). While plans in July were not as strong as those in April, it is clear that small business purchases should contribute significantly to third quarter growth. The caveat to overall inventory expectations is that the decline in plans among the inventory-intensive industries have dropped proportionately more than have expectations for the entire population. The major fall-offs occurred in construction and manufacturing; a clear slow-down occurred in retail; wholesale plans, though, actually improved a bit (Chart 3). Thus, while inventory plans appeared very positive, their industry composition fades the outlook somewhat.

Chart 3

NET PLANNED INVENTORY INCREASES (DECREASES)
BY SELECTED INDUSTRY

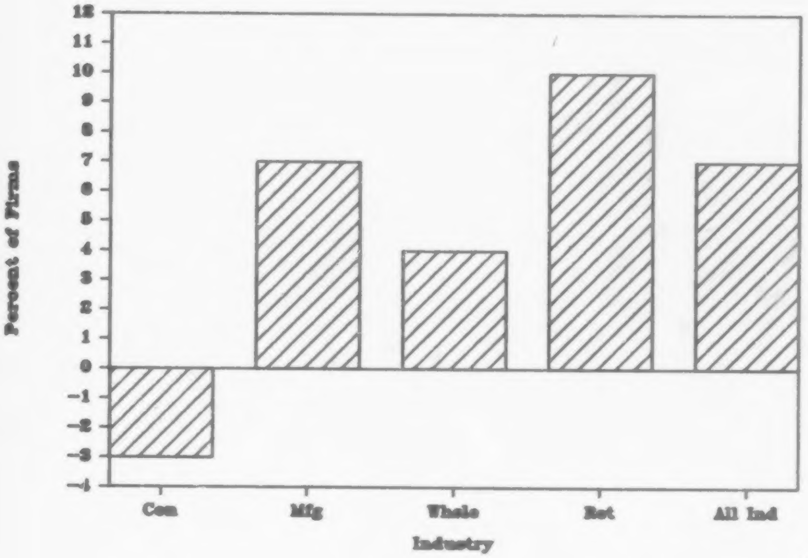


Table 8

NET INVENTORY CHANGE PLANNED IN NEXT QUARTER

PLANNED INVENTORY CHANGE	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Add	12	17	13	15	19	22	18
No Change	45	47	49	48	49	48	49
Decrease	25	17	18	18	12	11	11
Not Applicable	15	15	16	13	14	14	15
No Answer	3	4	4	6	6	5	7
Total	100%	100%	100%	100%	100%	100%	100%

Prices

Reported average selling prices rose slightly in the second quarter. The rise was marginally greater than that of the past three quarters, but clearly at a low enough level to sustain rediscovered price stability. The marginal increase over first quarter levels was not the result of more small business owners raising prices or raising prices by greater amounts. The identical percentage reported increases in July as had in April; further, the distribution of increases was the same (Table 9). Rather the marginal increase in the rate of price rises was the result of less frequent price cutting in the second quarter. Thirteen percent still were reporting lower average selling prices in July. However, the percentage of firms cutting prices fell from 17% in April and from a high of 20% in October, 1982.

Table 9

CURRENT AVERAGE SELLING PRICES COMPARED TO PREVIOUS QUARTER'S AVERAGE SELLING PRICES

AVERAGE	1980	1981	1982		1983		
SELLING PRICES	JUL	JUL	JUL	OCT	JAN	APR	JUL
Lower Now	9	10	16	20	18	17	13
No Difference	39	44	55	59	61	58	62
Higher Now	49	43	25	19	19	22	22
Less than 1%	1	1	1	*	*	1	1
1.0-1.9%	4	4	3	2	2	3	3
2.0-2.9%	6	4	3	3	3	4	4
3.0-3.9%	6	6	3	3	2	3	3
4.0-4.9%	5	5	3	2	3	3	3
5.0-7.9%	16	15	6	5	5	5	5
8.0-9.9%	6	5	1	1	1	1	1
10% or More	5	3	3	2	2	2	2
No Answer	*	*	2	1	1	*	*
No Answer	3	3	4	2	2	3	3
Total	100%	100%	100%	100%	100%	100%	100%

* Less than 0.5%

Construction was the only industry which altered its price structure substantially between April and July. The reduction in price cutting was the principal manner of change. Fourteen percent of construction firm owners reported lower prices in July compared to 27% with a similar report in April (Table 10). The number of construction firms increasing prices grew by only 3 percentage

Table 10

CURRENT AVERAGE SELLING PRICES COMPARED TO PREVIOUS QUARTER'S AVERAGE SELLING PRICES BY INDUSTRY

Average Selling Prices	Con	Mfg	Tran	Whsle	Ret	Agr	Fin	Serv	Prof
Lower	14	12	16	23	11	30	20	8	2
No Change	63	71	58	49	61	47	51	70	79
Higher	22	15	22	28	26	14	24	17	18
Don't Know	1	1	*	*	1	3	2	1	*
No Answer	*	1	4	*	1	6	3	4	1
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number	240	294	55	189	670	100	169	266	146

* Less than 0.5%

Table 11

PLANNED PRICE CHANGES FOR NEXT QUARTER

PLANNED	1980	1981	1982		1983		
PRICE CHANGES	JUL	JUL	JUL	OCT	JAN	APR	JUL
Lower	N.A.	N.A.	N.A.	5	5	4	3
No Change	39	40	56	57	55	58	58
Increase	34	36	20	19	22	18	20
Less than 1%	1	1	1	*	*	*	*
1.0-1.9%	2	3	2	1	2	2	2
2.0-2.9%	4	4	3	2	2	2	2
3.0-3.9%	3	8	2	2	2	3	3
4.0-4.9%	4	1	2	3	4	2	3
5.0-7.9%	10	9	5	5	6	5	5
8.0-9.9%	2	2	1	1	1	1	1
10% or More	4	4	2	3	3	2	2
Don't Know	4	4	2	2	2	1	2
Don't Know	21	17	17	17	15	16	16
No Answer	6	7	7	2	3	4	3
Total	100%	100%	100%	100%	100%	100%	100%

*Less than 0.5%
N.A. Not Available

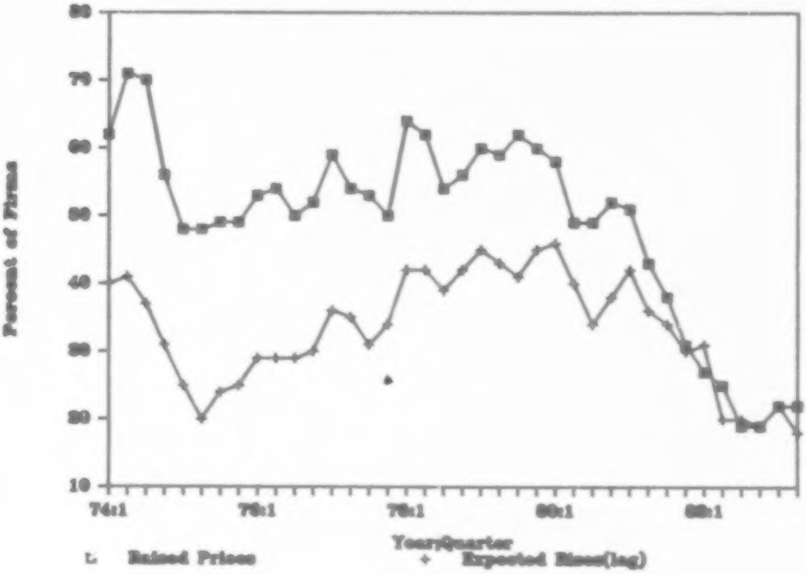
points, however. The financial services industry, closely allied to construction, encountered the second greatest degree of price changes.

The increasing strength of home building has allowed prices to firm in the ailing construction industry. However, with the possible exception of transportation (too few respondents from which to generalize) caused by recent cost increases for vehicle fuels, there appeared to be no major pressures from economic expansion pushing prices higher. With inflation under control, the percent of firms planning price increases approximates those actually reporting them three months later (Chart 4).

The near-term outlook for inflation remains good. Average small business selling prices were expected to increase at approximately the same rate in the third quarter as they did in the second quarter

Chart 4

EXPECTED AND REALIZED PRICE INCREASES



(Table 11). In fact, over the last six surveys, dating back through April, 1982, expectations of small business price changes have varied little. The result has been a series of projections for CPI minus food in the 3.0-4.0% (annualized rate) range. These have accurately forecast the underlying inflation rate, although they have missed some wild swings in the CPI minus food figures resulting from measurement problems.

Employment

For the first time since the second quarter of 1981 on a seasonally unadjusted basis and the third quarter of 1979 on a seasonally adjusted basis, employment among operating small businesses increased. One in five firms added to its labor force; slightly more than one in ten (12%) lost part of it (Table 12). The last time a greater percentage of firms reported increased hiring was July, 1979; the last time a smaller percentage of firms reported reductions was April, 1979. With the average number of new hires per expanding firm identical to the average number of job losses per contracting firm, average net employment rose 0.3 employees per firm.

Table 12

AVERAGE EMPLOYMENT CHANGE IN PAST QUARTER

	Percent of Firms				Number of Employees			
EMPLOYMENT	1982	1983			1982	1983		
CHANGE	OCT	JAN	APR	JUL	OCT	JAN	APR	JUL
Increased	12	10	13	20	4.3	3.3	2.6	3.7
Seasonal	4	3	4	9				
Nonseasonal	8	7	9	11				
Decreased	20	18	16	12	3.7	4.6	3.8	3.7
Seasonal	4	6	5	3				
Nonseasonal	16	12	11	9				
No Change	67	71	69	66				
No Answer	1	1	2	2				
Total	100%	100%	100%	100%	--	--	--	--
Average net change per firm	--	--	--	--	-.22	-.47	-.28	+.30

Average employment increased in all industries. However, it was the production industries, i.e. construction and manufacturing, which provided the bulk of new hires on a per firm basis; the service industries lagged. The distribution of new hires is not surprising. Employment in small construction and manufacturing firms has demonstrated considerably more volatility than has employment in the other small business industries. The services have been more stable. In fact, it wasn't until the 4th quarter of 1981 that the service industries experienced a net employment loss. Further, the rebound of the housing industry from its depressed levels as well as the attempted run-up in inventories provided both production industries a strong stimulant. Thus, principal, though by no means all responsibility, for the second quarter employment increases among operating small businesses lay in the altered fortunes of two industries.

Current job openings rose 3 percentage points between April and July, for its best reading in two years (Table 13). Still, only 13% of small business reported a job opening--a very low number compared to even the early part of the 80's. As can be see on Chart 5, the

Chart 5

CURRENT JOB OPENINGS

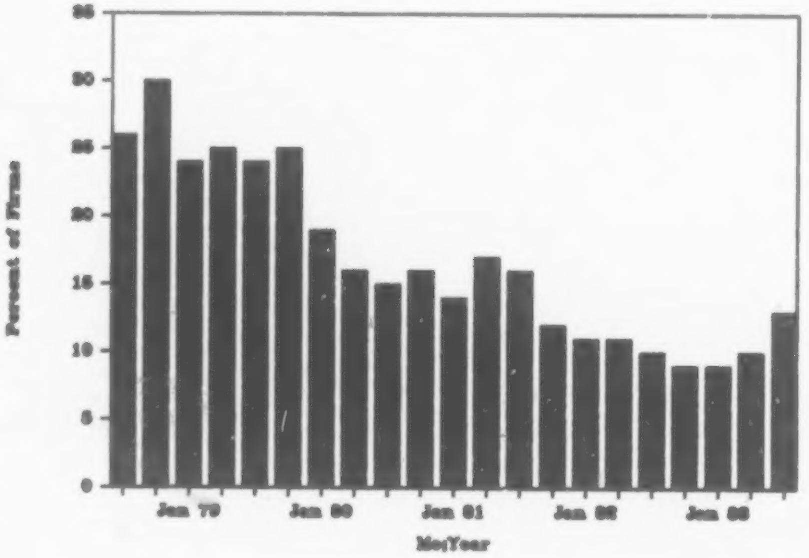


Table 13

CURRENT JOB OPENINGS

CURRENT JOB OPENINGS	1980	1981	1982		1983		
	JUL	JUL	JUL	OCT	JAN	APR	JUL
Yes	15	16	10	9	9	10	13
Skilled Labor	12	13	8	7	7	8	11
Unskilled Labor	1	1	1	1	1	1	1
Both	2	2	1	1	1	1	1
No	85	83	88	90	89	88	85
No Answer	*	1	2	1	2	2	2
Total	100%	100%	100%	100%	100%	100%	100%

* Less than 0.5%

percentage of firms with at least one current job opening began to fall in 1980 and has continued to do so at regular intervals since. The July data probably represent a reversal in that trend. But just as it took a considerable period to close down those job openings, it may take a considerable time to reopen them.

There is no indication that a hiring binge reminiscent of the late 70's is in the offing. However, expected labor force changes for the third quarter indicated that another significant net increase in small business employment is to be anticipated. Sixteen percent reported plans to increase their labor forces; 7% reported plans to decrease them (Table 14). That is the best July reading

Table 14

EXPECTED NET LABOR FORCE CHANGES IN NEXT QUARTER

NET LABOR FORCE CHANGE EXPECTATION	1980	1981	1982			1983	
	JUL	JUL	JUL	OCT	JAN	APR	JUL
Increase	12	14	10	10	14	21	16
Keep the Same	75	75	77	75	76	71	74
Decrease	12	10	11	14	8	6	7
No Answer	1	1	2	1	2	2	3
Total	100%	100%	100%	100%	100%	100%	100%

and, seasonally adjusted, one of the better readings in the survey's ten year history. However, when factoring in the historic underestimation in job losses, the net gain in firms increasing employment should be in plus 4-5 percentage point range.

These reported plans must be considered very positive, but they could evaporate. Manufacturing and construction were the industries in which the strongest employment plans lay (Table 15). However, a perceived change in consumer demand, whether or not interest rate-related, could change the green light to a flashing yellow.

Table 15

EXPECTED NET LABOR FORCE CHANGE IN NEXT QUARTER BY INDUSTRY

NET LABOR FORCE CHANGE EXPECTATION	Con	Mfg	Tran	Whsle	Ret	Agr	Fin	Serv	Prof
Increase	25	25	13	19	11	13	11	14	15
Same	69	67	80	71	78	65	81	75	75
Decrease	6	5	6	9	8	15	5	6	7
No Answer	*	3	1	1	3	7	3	5	3
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number	240	294	55	189	670	100	169	266	146

* Less than 0.5%

Capital Expenditures

Fifty-three percent of responding firms in July reported having made at least one capital expenditure in the last six months (Table 16). The figure was four percentage points higher than the one recorded in April and the highest percentage in over a year. However, actual expenditure frequency was lower than in either July, 1980, or July, 1981.

The average size of total capital expenditures edged lower. Forty-eight percent of responding firms reported outlays totalling less than $10,000 (Table 17). That figure represented the largest percentage of investments under $10,000 since the second half of 1980, as recorded in January, 1981.

Capital expenditures by small businesses have been nowhere and are going nowhere. Plans to make a capital expenditure in the next

Table 16

PERCENT MAKING CAPITAL EXPENDITURES IN LAST SIX MONTHS

TYPE OF EXPENDITURE	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
All Types+	56	54	47	48	50	49	53
Equipment/ Vehicles	43	44	37	38	40	40	42
Add Buildings	7	7	6	7	6	6	7
Improved Buildings	18	16	16	15	15	14	15
Land	5	4	3	3	3	4	4

+Percent of firms making one or more capital expenditures

Table 17

CAPITAL EXPENDITURES MADE IN LAST SIX MONTHS BY SIZE OF TOTAL EXPENDITURES

AMOUNT OF EXPENDITURES (000's)	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Under $1	7	7	9	8	8	7	7
$1 - 4	19	19	23	21	22	19	22
$5 - 9	19	18	15	18	16	18	19
$10 - 19	19	18	20	19	19	20	19
$20 - 49	16	16	14	14	14	17	14
$50 - 99	8	8	8	7	8	8	7
$100 - 499	9	10	7	9	9	7	7
$500 - 999	1	2	1	2	1	1	1
$1,000 or More	1	1	1	1	1	*	1
No Answer	1	1	2	1	2	3	3
Total	100%	100%	100%	100%	100%	100%	100%

* Less than 0.5%

three to six months fell two percentage points from April to 28% (Table 18). While better than plans recorded one year ago, they remained weak by any reasonable comparison.

Table 18

EXPECTED CAPITAL EXPENDITURES IN NEXT THREE TO SIX MONTHS

CAPITAL EXPENDITURES EXPECTATIONS	1980	1981	1982		1983		
	JUL	JUL	JUL	OCT	JAN	APR	JUL
Yes	26	30	22	24	29	30	28
No	62	58	64	62	58	54	55
Don't Know	12	11	13	11	10	13	13
No Answer	*	1	1	3	3	3	4
Total	100%	100%	100%	100%	100%	100%	100%

* Less than 0.5%

A solid increase in capital expenditures continued to be elusive.

Credit Conditions

Interest rates on short-term loans declined only marginally in the second quarter (from 13.5% in the first quarter to 13.2%), reflecting the reluctance of rates to continue their downward trend (Table 19 and Table 20). One year ago, the average rate stood at

Table 19

INTEREST RATE PAID ON SHORT-TERM LOANS

INTEREST RATE	1980	1981	1982		1983		
	JUL	JUL	JUL	OCT	JAN	APR	JUL
Under 13%		1	1	1	8	14	18
13%-15%		5	4	19	32	36	37
16%-18%		34	52	37	20	11	8
19%-22%	N.A.	48	11	5	2	2	2
23% or More		5	*	*	*	*	*
Prime, +1#		4	18	23	23	20	19
Prime +2		2	12	12	13	14	13
Prime +3 or More		1	2	3	2	3	3
Total		100%	100%	100%	100%	100%	100%
AVERAGE RATE		19.0%	17.6%	15.4%	14.1%	13.5%	13.2%

*Less than 0.5%
#"Prime +____" response added in 1982
N.A. Not available

15.4%, and two years ago, 19.3%. However, the spread between the "small business rate" and the average national prime increased over the period (Chart 6).

Table 20

CURRENT INTEREST RATE COMPARED TO INTEREST RATE IN PRIOR QUARTER

RELATIVE INTEREST RATES	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Much Higher	4	8	1	1	*	*	*
Higher	7	23	8	2	1	2	5
Same	5	12	25	10	7	10	19
Lower	18	1	5	25	28	29	17
Much Lower	6	*	*	3	3	2	*
Don't Know	1	1	1	1	1	1	1
Inapplicable (Borrow Infrequently; No Answer)	59	55	60	58	60	56	58
Total	100%	100%	100%	100%	100%	100%	100%

*Less than 0.5%

Forty-two percent of small business owners reported borrowing on a regular basis (at least once every three months), down from 44% in April (Table 21). The highest borrowing rate (51%) occurred in January, 1979, and the lowest (39%) on several occasions in the mid-70's. Improved earnings and relatively low inflation rates should continue to place downward pressure on small business borrowing needs, but increasing economic activity--particularly inventory growth--offers counter-pressure. Therefore, it remains an open question as to what extent small business will challenge other potential borrowers once Federal government requirements swallow the lion's share of available funds.

Thirty-five percent of borrowing firms, a growing number, reported their loans tied to the prime rate. At least for these firms, credit costs will rise in the third quarter. However, the traditional relationship (in the late 70's and 80's) between small business rates and the prime has been lead-lag. Changes in small business rates have lagged changes in the prime. If this relationship continues, the average small business cost in the third quarter should not reflect the total third quarter prime rate rise.

Chart 6

SPREAD BETWEEN AVERAGE SMALL BUSINESS INTEREST RATE AND THE PRIME RATE

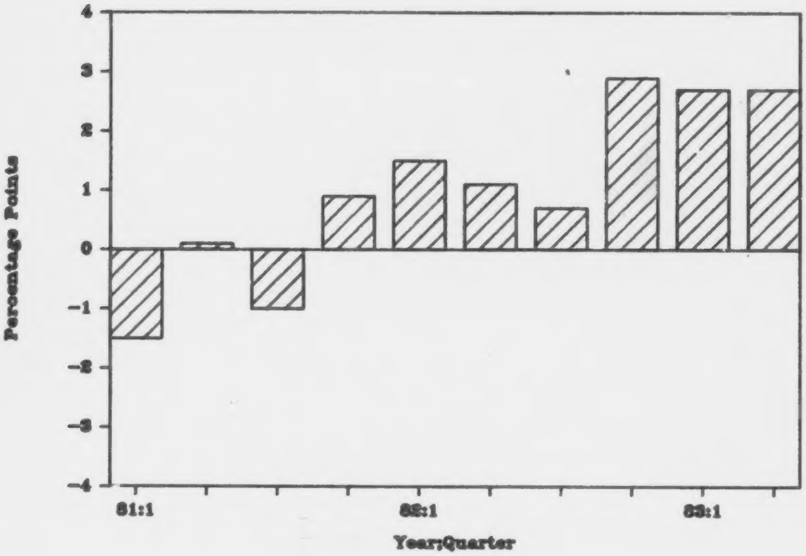


Table 21

AVAILABILITY OF LOANS
COMPARED TO PRIOR THREE MONTHS

LOAN AVAILABILITY	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Easier	5	11	1	2	4	6	5
Same	25	32	26	29	28	29	30
Harder	9	11	11	8	6	6	6
Don't Know	2	1	2	3	2	3	1
Inapplicable (Don't Borrow; No Answer)	59	55	60	58	60	56	58
Total	100%	100%	100%	100%	100%	100%	100%

*Less than 0.5%

Small business owners remained relatively positive over the future course of interest rates despite gloomy reports from financial centers. For example, only seven percent expected borrowing to become more difficult in the next three to six months, with 4% taking the opposite view (Table 22). Such an assessment is similar to that reported throughout 1983 and considerably better than 1982.

Table 22

EXPECTED FINANCING CONDITIONS NEXT QUARTER
COMPARED TO THE CURRENT QUARTER

CREDIT EXPECTATIONS	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Easier	7	2	1	3	4	6	4
Same	23	25	23	26	25	29	28
Harder	7	14	13	10	7	6	7
Don't Know	4	4	3	3	4	3	3
Inapplicable (Don't Borrow; No Answer)	59	55	60	58	60	56	58
Total	100%	100%	100%	100%	100%	100%	100%

Accounts Receivable

The percentage of accounts receivable over 30 days (presumed delinquent) again slipped. Forty-four percent of small business owners reported fewer than 11% of their receivables more than 30 days in contrast to 42% in April and 37% one year ago (Table 23). The change in those classes 26% and above, however, has been negligible.

Though the shift toward more rapid payment of bills owed small firms has been very gradual, there seems little doubt that a change has occurred and that the direction of the change has been toward fewer receivables over 30 days. The question is whether or not the change means anything. One obviously assumes that more rapid repayment of debt indicates greater liquidity and a more healthy economic condition. Preliminary evidence seems to indicate that a demonstrable relationship between the two exists, but the changes recorded thus far are so small and so painfully slow, the hypothesized relationship won't be verifiable for a considerable period.

Table 23

PERCENT OF RECEIVABLES OVER THIRTY DAYS

	1980	1981	1982		1983		
PERCENT	JUL	JUL	JUL	OCT	JAN	APR	JUL
Less than 1%	N.A.	N.A.	10	12	10	10	13
1%-5%			15	16	17	18	18
6%-10%			12	12	12	14	13
11%-15%			9	7	9	9	10
16%-25%			13	14	13	11	12
26%-50%			12	13	12	11	11
51% or More			5	6	6	6	5
Not Applicable			18	16	17	17	15
No Answer			6	4	4	4	4
Total			100%	100%	100%	100%	100%

N.A. Not available

Optimism

Small business owner attitudes toward the economy's course remained remarkably positive. Sixty-one percent of the respondents expected general business conditions to improve over the next three to six months (Table 24). While that figure is 7 percentage points fewer than recorded in April, it is 19 percentage points higher than that of July, 1982, and 18 percentage points higher than that of July, 1981. The highest figure recorded in the recovery from the

Table 24

EXPECTED GENERAL BUSINESS CONDITIONS OVER NEXT THREE TO SIX MONTHS COMPARED TO CURRENT QUARTER

EXPECTED	1980	1981	1982		1983		
CONDITIONS	JUL	JUL	JUL	OCT	JAN	APR	JUL
Much Better	3	3	3	4	4	7	7
Better	35	40	39	47	52	61	54
Same	34	38	37	32	32	24	31
Worse	17	10	10	9	6	3	4
Much Worse	3	1	2	2	1	1	*
Don't Know	7	7	8	6	5	4	4
No Answer	1	1	1	*	*	*	*
Total	100%	100%	100%	100%	100%	100%	100%

* Less than 0.5%

1974-1975 recession was 51%. The most recent figure becomes even more impressive considering its relative nature. When the economy is poor, even a modestly positive change is an "improvement." But with the economy clearly having surged in the second quarter, continued improvement would require a substantial gain.

Since April, 1979, the percentage of small business owners believing the next three months a good time for small business expansion has reached double digit levels only twice. The first was in April, 1981, when 10% responded affirmatively and the second was in April, 1983, when 19% did so. In July, 23% of respondents felt the next three months would be a good time for small business expansion (Table 25). Only April, 1976, and April, 1977, provided more positive responses, and then only by one percentage point.

The north central regions of the country were clearly the least optimistic (Table 26). Nearly half of all respondents were negative in their view of the climate for small business expansion.

Those small entrepreneurs with positive views on the climate for expansion tended to attribute their optimism to general economic conditions (59%) (Chart 7). Sales prospects (24%), financing and interest rates (10%), and cost of expansion (4%) followed as principal reasons. Those with negative views on the climate for expansion also cited general economic conditions most frequently (49%), however, financing and interest rates (21%) and materials costs (11%) were relatively more important. The 35% of respondents who were uncertain often appeared to have a specific reason for their uncertainty. Finance and interest rates (22%) and material costs (20%) were the most important.

Table 25

CLIMATE FOR SMALL BUSINESS
EXPANSION IN NEXT QUARTER

GOOD TIME TO EXPAND	1980 JUL	1981 JUL	1982 JUL	1982 OCT	1983 JAN	1983 APR	1983 JUL
Yes	9	8	5	7	9	19	23
No	69	69	75	74	67	48	42
Uncertain	21	22	19	19	23	32	35
No Answer	1	1	1	*	1	1	*
Total	100%	100%	100%	100%	100%	100%	100%

*Less than 0.5%

Table 26

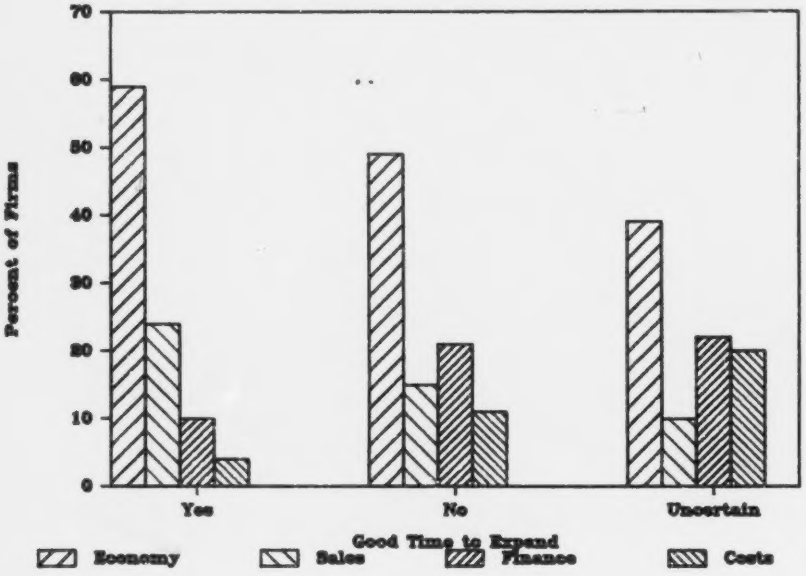
CLIMATE FOR SMALL BUSINESS EXPANSION
IN NEXT QUARTER BY REGION

GOOD TIME TO EXPAND	New Eng	Mid Atl	EN Cent	WN Cent	So Atl	ES Cent	WS Cent	Mnt	Pac
Yes	21	21	16	20	30	28	27	21	24
No	30	39	48	50	38	38	44	43	38
Uncertain	49	40	35	29	32	34	29	35	37
No Answer	*	*	1	1	*	*	*	1	1
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number	87	220	361	306	244	100	244	195	374

* Less than 0.5%

Chart 7

REASONS FOR VIEWS ON THE CLIMATE FOR
SMALL BUSINESS EXPANSION BY VIEW HELD



Certainty regarding the economy's positive direction has been increasing, as evidenced by the distribution of reasons provided by small business owners for their views on the climate for expansion. Those with positive attitudes have increasingly cited general business conditions, while those with negative attitudes or who are uncertain less frequently cite general business conditions. However, the rise in financing and interest rates among the latter two groups indicates that the overall economy has been improving considerably faster than the financing component. The latter fact is a recurrent theme throughout this report.

Optimism Index

The Index of Small Business Optimism reached a new high in July, edging past the previous record established only three months earlier (Chart 8). April's Index forecast a change in real GNP of 8.6% for the second quarter--a figure generally considered outrageously high at the time--but real growth eventually measured 8.7%. The July Index forecast a change in real GNP of 8.9% for the third quarter--a figure even more outrageous than April's accurate projection.

Two of the three principal components of the Index retreated from April. General expectations, consisting of the softest measures, was one of those which ebbed. Little change occurred in any of its parts. However, by historical standards this component remained very high and was clearly the component responsible for the Index records established in both April and July. Slippage from April also occurred in the spending plans component of the Index. Plans to hire, add inventory, and make a capital expenditure all edged lower, but the component was still the fourth highest in the ten year history of the survey.

The current status component led by change in net earnings jumped and pushed the Index above April's level. However, the component wasn't particularly high by historic measures. Current job openings was the drag, although it too was higher than in April. Inventory satisfaction also remained very positive.

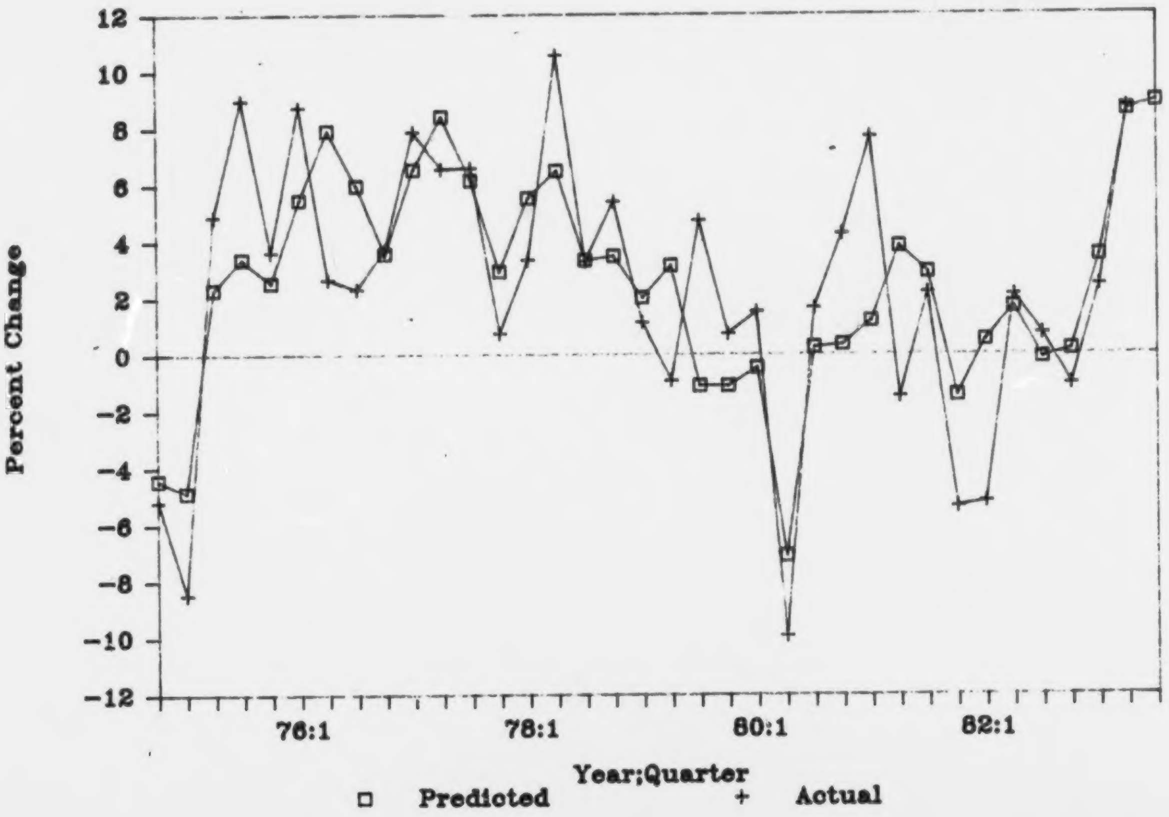
Single Most Important Problem

No single problem appears to dominate the concern of small business as "Inflation" or "Interest Rates-Financing" once did. "Taxes," which now heads the list, was cited as the single most important problem by only 22% of small business owners (Table 27). "Poor Sales" and "Interest Rates-Financing" shared second place, each being cited by 18% of respondents. "Competition from Large Business" followed at 9%. One percentage point fewer named "Inflation," matching the survey low for that problem recorded one quarter earlier.

The share of attention that "Taxes" draws has grown steadily over the last year. Continued escalation of payroll taxes, state and local initiatives to fund projected deficits, and TEFRA all

Chart 8

PREDICTED AND ACTUAL QUARTERLY CHANGES IN G.N.P.



undercut any benefit resulting from the Federal three year income tax program--a fact which seems all too obvious to many small business owners. However, a respite in an array of negative economic conditions was also an important factor pushing "Taxes" to the fore. With recovery and the reduction in interest and inflation rates, other persistent concerns, most notably taxes, tend to rise in relative priority.

The continued frequent mention of "Poor Sales" and "Interest Rates-Financing" indicated that soft spots in the small business economy still exist. By historical standards, the 18% citing "Poor Sales" and "Interest Rates-Financing" as the single most important problem was high. Some small firms obviously did not realize the strong second quarter sales and others were wary of continued high interest rates and their direction. Manufacturing, wholesaling, and retailing provided the focus of attention on "Poor Sales." Construction and financial services provided it on "Interest Rates-Financing."

Chart 9

THE FOUR MOST FREQUENTLY CITED SINGLE MOST IMPORTANT PROBLEM BY INDUSTRY

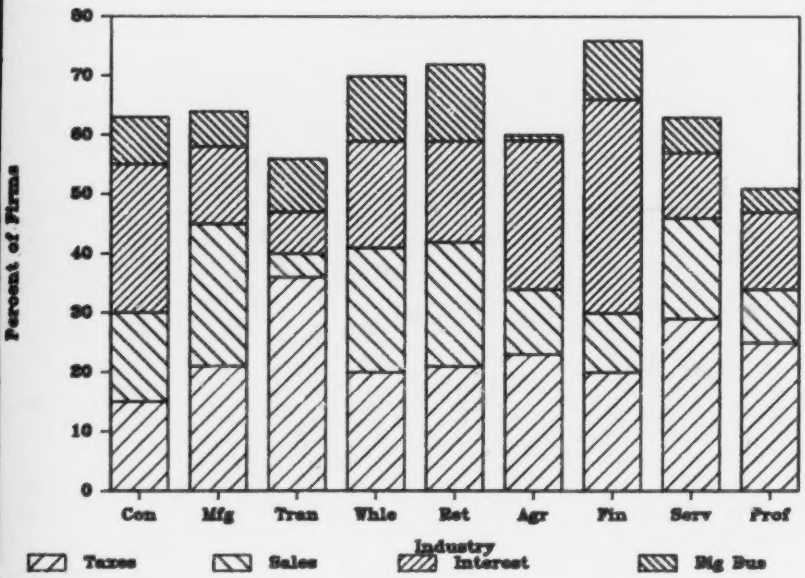


Table 27

SINGLE MOST IMPORTANT PROBLEM

MOST IMPORTANT PROBLEM	Prior High		Prior Low		1982 OCT		1983 JAN		APR		JUL	
	Date	%	Date	%	Rank	%	Rank	%	Rank	%	Rank	%
Taxes	1/78+	22	9/74	8	3	13	3	18	2	20	1	22
Inflation	9/74	41	4/83	8	4	12	4	9	5	8	5	8
Poor Sales	9/82	23	1/75+	1	2	23	1	22	1	22	2	18
Interest Rates & Financing	4/82+	37	7/77	4	1	25	2	20	3	18	2	18
Cost of Labor	7/77	9	7/82	2	7	4	7	4	7	4	8	4
Government Regulations(s)/ Red Tape	4/76	16	7/82+	4	5	6	5	8	4	9	5	8
Competition from Large Business	9/76	13	4/80+	4	5	6	6	7	5	8	4	9
Quality of Labor	4/74+	10	1/83+	3	8	3	8	3	7	4	7	5
Shortage of Fuels, Materials, Goods	1/74	23	4/83+	*	9	*	9	*	9	*	9	*
Other; No Answer	-	-	-	-	-	8	-	9	-	7	-	8
Total	-	-	-	-	100%		100%		100%		100%	

* Less than 0.5%
+ Most recent

APPENDIX A

TABLE A-1
DESCRIPTION OF INDUSTRY CLASSIFICATIONS

Construction	Construction (Building contractors—general, painting, carpentry, plumbing, heating, electrical, etc., highway & bridge contractors, swimming pool construction, etc.)
Manufacturing	Manufacturing and mining (including dairy processor, printer, publisher)
Transportation	Transportation, travel agency, communication, public utilities (truckers, movers, broadcasters, etc.)
Wholesale	Wholesale (including grain elevator, livestock dealer, distributor of construction equipment, etc.)
Retail	Retail sales (including food store, service station, restaurant, bar, radio and TV store, drug store, furniture and appliances, auto dealer, etc.)
Agriculture	Agriculture, veterinarian, forestry, landscaping, fisheries
Financial Services	Finance companies, insurance, real estate, banks, savings & loans, etc
Nonprofessional Services	Beauty salon, barber shop, garage, motel, hotel, repair service, bookkeeping service, photographer, funeral director, rental agency, credit bureau, laundry, etc.
Professional Services	Physician, dentist, attorney, optometrist, engineer, architect, accountant, skilled nursing care facility, etc.

TABLE A-2
DEFINITION OF REGIONS

REGION	STATES INCLUDED IN REGION
New England	Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont
Mid-Atlantic	New Jersey, New York, Pennsylvania
East North Central	Illinois, Indiana, Michigan, Ohio, Wisconsin
West North Central	Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
South Atlantic	Delaware, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia, (also includes Washington, D.C.)
East South Central	Alabama, Kentucky, Mississippi, Tennessee
West South Central	Arkansas, Louisiana, Oklahoma, Texas
Mountain	Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming
Pacific	Alaska, California, Hawaii, Oregon, Washington

TABLE A-3
SALES OF FIRM BY INDUSTRY

SALES OF FIRM[2]	INDUSTRY[1]									
	Construction	Manufacturing	Transportation	Wholesale	Retail	Agriculture	Financial Services	Nonprofessional Services	Professional Services	ALL FIRMS—[3] JUL 1983
Less than $50,000	8	4	4	1	8	12	9	21	8	9
$50,000—99,999	14	8	17	3	11	22	12	19	20	13
$100,000—199,999	13	11	14	6	19	19	20	21	34	17
$200,000—349,000	13	12	11	8	14	23	12	14	11	13
$350,000—799,999	19	19	14	18	20	9	14	12	12	17
$800,000—1,499,999	13	16	22	17	13	2	8	6	8	12
$1,500,000—2,999,999	10	14	7	20	7	7	10	3	4	9
$3,000,000 or More	9	14	9	23	7	5	12	2	*	8
Not Ascertained	1	2	2	4	1	1	3	2	3	2
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number of Firms	240	294	55	189	670	100	169	266	146	2131
Percent of Firms	11	14	2	9	32	4	8	13	7	

[1] See Table A-1 for detailed description of these classifications

[2] Quarter sales, at annual rates

[3] Includes 2 firms for which no industrial classification was ascertained

[4] Less than 0.5%

TABLE A-4
NUMBER OF EMPLOYEES BY INDUSTRY

NUMBER OF EMPLOYEES	INDUSTRY									
	Construction	Manufacturing	Transportation	Wholesale	Retail	Agriculture	Financial Services	Non-professional Services	Professional Services	ALL FIRMS—[1] JUL 1983
1	6	2	3	3	6	13	10	10	7	6
2	7	5	9	2	8	12	17	16	14	9
3—5	24	16	17	24	33	34	40	34	40	29
6—9	15	20	17	22	21	18	12	19	16	19
10—14	20	13	18	19	13	5	5	10	5	13
15—19	6	7	11	12	7	2	5	2	5	6
20—39	12	16	13	12	7	4	3	6	7	9
40 or More	9	20	7	6	4	10	6	2	4	8
No Answer	1	1	5	*	1	2	2	1	2	1
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Number of Firms	240	294	55	189	670	100	169	266	146	2131

[1] Includes 2 firms for which no industrial classification was ascertained

* Less than 0.5%

NFIB QUARTERLY ECONOMIC SURVEY

Please circle the appropriate answers or fill in the blanks.

1. What is your form of business organization?
1 Proprietorship   2 Partnership   3 Corporation   1

2. Please classify your major business activity, using one of the categories of examples below. (If more than one applies, circle *the one* which contributes the most toward your gross sales or total revenues.)
1 Construction (general contractor, painting, carpentry, plumbing, heating, electrical, highway, *etc.*)
2 Manufacturing and mining (including dairy processor, printer, publisher, *etc.*)
3 Transportation, travel agency, communication, public utilities (truckers, movers, broadcasters, *etc.*)
4 Wholesale (including grain elevator, livestock dealer, distributor of equipment, manufacturer's rep., *etc.*)   2
5 Retail (including service station, restaurant, bar, radio and TV store, drug store, florist, apparel, *etc.*)
6 Agriculture, veterinarian, forestry, landscaping, fisheries, *etc.*
7 Financial, insurance, real estate, bank, savings & loan, *etc.*
8 Beauty salon, barber shop, garage, motel, hotel, repair service, bookkeeping service, photographer, funeral director, rental agency, credit bureau, laundry, *etc.*
9 Physician, dentist, attorney, engineer, architect, accountant, skilled nursing care facility, *etc.*
10 Other (please describe) ________________________

3. What is the single most important problem facing your business today? (Please circle only **ONE** of the following):
1 Taxes   4 Interest rates & financing   8 Quality of labor   3
2 Inflation   5 Cost of labor   9 Shortage of fuels, materials or goods
3 Poor Sales   6 Government regulation(s) & red tape   0 Other ________________
7 Competition from large businesses   (please explain)

4. Do you think the ***next three months*** will be a good time for small business to expand substantially?
1 Yes   2 No   3 Uncertain   4

4a. Why? (Circle **ONE** answer—***most important reason***)
1 Economic conditions   3 Financing & interest rates   5 Other________________   5
2 Sales prospects   4 Cost of expansion   (please explain)

5. About the economy in general, do you think that ***six months from now*** general business conditions will be better than they are now, about the same, or worse?
1 Much better   3 About the same   5 Much worse   6
2 Somewhat better   4 Somewhat worse   6 Don't know

6. During the last 3 months or calendar quarter, what were your gross sales, or revenues?
1 Under $12,500   3 $25,000-49,999   5 $87,500-199,999   7 $375,000-749,999   7
2 $12,500-24,999   4 $50,000-87,499   6 $200,000-374,999   8 $750,000 or more

6a. During the ***last calendar quarter***, was your dollar sales volume higher, lower, or about the same as it was ***for the quarter before***?
1 Much higher   2 Higher   3 About the same   4 Lower   5 Much lower   8

6b. If higher or lower, by approximately what percentage?
1 Less than 6%   3 11%—15%   5 21%—25%   7 36%—50%   9
2 6%-10%   4 16%—20%   6 26%—35%   8 51% or more

7. Were your net earnings or "income" (after taxes) from your business during the ***last calendar quarter*** higher, lower, or about the same as they were ***for the quarter before***?
1 Much higher   2 Higher   3 About the same   4 Lower   5 Much lower   10

7a. If higher or lower, by approximately what percentage?
1 Less than 6%   3 11%—15%   5 21%—25%   7 36%—50%   11
2 6%-10%   4 16%—20%   6 26%—35%   8 51% or more

7b. If higher or lower, what is the ***most important reason***? (Circle only ONE) 12
1 Sales volume 4 Availability of materials 6 Financing costs
2 Labor costs 5 Received higher prices for your product or service 7 Usual seasonal change
3 Cost of materials 8 Other ______________ (Specify)

8. Overall, what do you expect to happen to the real ***volume*** (number of units) of goods and/or services that you will sell during the ***next three months***? 13
1 Go up a lot 3 Stay the same 5 Go down a lot
2 Go up a little 4 Go down a little 6 Don't know

9. How are your average selling prices now compared to three months ago? 14
1 Lower now 2 No difference 3 Higher now 4 Don't know

9a. If **higher** or **lower**, by what percent, on an average? 15
1 Less than 1% 3 2.0-2.9% 5 4.0-4.9% 7 8.0-9.9% 9 Don't know
2 1.0-1.9% 4 3.0-3.9% 6 5.0-7.9% 8 10% or more

10. In the ***next three months***, do you plan to ***change*** the average selling prices of your goods and/or services? 16
1 Yes, raise prices 2 Yes, lower prices 3 No change 4 Don't know

10a. If raise or lower, by what percent, ***on average***? 17
1 Less than 1% 3 2.0-2.9% 5 4.0-4.9% 7 8.0-9.9% 9 Don't know
2 1.0-1.9% 4 3.0-3.9% 6 5.0-7.9% 8 10% or more

11. How many employees do you have full and part-time ***including yourself***? 18
1 One 3 3-5 5 10-14 7 20-39
2 Two 4 6-9 6 15-19 8 40 or more

12. During the ***last three months***, did the ***total*** number of employees in your firm increase, decrease, or stay about the same? 19 21
1 Increased by _____ employee(s) 2 Decreased by _____ employee(s) 3 Stayed the same

12a. If the ***total number*** of employees increased or decreased, was this change due primarily to ***seasonal factors*** affecting your business? 22
1 Yes 2 No

13. In the ***next three months***, do you expect to increase or decrease the total number of people working for you? 23
1 Increase 2 Keep the same 3 Decrease

14. Do you have any job openings that you are ***not*** able to fill right now? 24
1 Yes, for skilled labor 3 Yes, both skilled and unskilled labor
2 Yes, for unskilled labor 4 No

14a. If you have any openings, about how long have these jobs been available? (Circle **ONE** category which best describes your overall situation): 25
1 Less than one month 3 Three months, but less than six months
2 One months, but less than three months 4 Six months or more

15. During the last three months, did you increase or decrease your inventories? 26
1 Increase 2 About the same 3 Decrease 4 Not appropriate

15a. If increase or decrease, by approximately what percent? 27
1 Less than 6% 3 11%—15% 5 21%—25% 7 36%—50%
2 6%-10% 4 16%—20% 6 26%—35% 8 51% or more

16. At the present time, do you feel your inventories are too large, about right, or inadequate? 28
1 Too large 2 About right 3 Too low 4 Not appropriate

16a. Looking ahead to the next three to six months, do you expect, on balance, to add to your inventories, keep them about the same, or decrease them? 29
1 Add 2 Keep the same 3 Decrease 4 Not appropriate

(See next page)

17 If you borrow money regularly (at least once every 3 months) as part of your business activity, how does the rate of interest payable on your most recent loan compare with that paid ***three months ago***?

☐1 Much higher ☐3 Same ☐5 Much lower ☐7 Inapplicable, do not borrow regularly 30
☐2 Higher ☐4 Lower ☐6 Don't know

17a. Are these loans easier or harder to get than they were ***three months ago***?

☐1 Easier ☐2 Same ☐3 Harder ☐4 Don't know 31

17b. Do you expect to find it easier or harder to obtain your required financing during the ***next three months***?

☐1 Easier ☐2 Same ☐3 Harder ☐4 Don't know 32

18. If you borrowed within the last three months for business purposes, and the loan maturity (pay back period) was 1 year or less, what interest rate did you pay? ____________________ % or Prime + ____________________ 33 35

19. During ***the last 6 months*** has your firm made any capital expenditures to improve or purchase equipment, buildings, or land? (Check all that apply)

Equipment, Vehicles: ☐1 Yes 36
Additional Buildings: ☐1 Yes 37
Improved Buildings: ☐1 Yes 38
Additional Land: ☐1 Yes 39

19a. ***If yes***, what was ***the total cost*** of these projects (i.e. total purchase price)?

☐1 under $1,000 ☐4 $10,000-19,999 ☐7 $100,000-499,999 40
☐2 $1,000-4,999 ☐5 $20,000-49,999 ☐8 $500,000-999,999
☐3 $5,000-9,999 ☐6 $50,000-99,999 ☐9 $1 million or more

20. Looking ahead to the next three to six months, do you expect to make any captial expenditures for plant and/or physical equipment?

☐1 Yes ☐2 No ☐3 Don't know 41

21. What percent of your accounts receivable (bills owed you) are over 30 days?

☐1 Not Applicable ☐3 1%-5% ☐5 11%-15% ☐7 26%-50% 42
☐2 Less than 1% ☐4 6%-10% ☐6 16%-25% ☐8 51% or more

22. Please indicate the geographical area that best describes the community in which your business is located

☐1 A metropolitan/urban area (population of over 100,000 in city and immediate area) 43
☐2 A small city (population over 15,000 but under 100,000 in city and immediate area)
☐3 A rural area (population under 15,000 in city and surrounding communities)

Mr. **Nowak**. Thank you very much. We looked at several areas of concern that you've touched on, Mr. Dennis, and certainly the association, the so-called personal touch, the personal knowledge of individual communities is a very real one when a new institution comes out with a new evaluator.

Have you had any indication from any of your members that this has put a particular strain on a businessman to continue to operate or, in the alternative, has he had an opportunity to go to another institution in that community?

Mr. **Dennis**. Smaller firms are tending to shop around a little bit more than they have in the past. They are certainly being solicited by more banks than they have in the past, although not by enormous percentages, and those solicitations tend to be toward certain types of firms. In other words the very largest of the small firms, presumably the better risk.

However, one thing that's important to recognize, and that is most small firms do not consider the price of the loan to be the most important factor in their bank relationship. The two most important factors in their relationships with their bank are, does the bank know me and my business, and the second one is, is it a reliable source of credit.

Price comes only third. So one of the reasons smaller firms don't shop around more than they have in the past, than they would for some other commodity, is that they are very concerned about the reliability of this entire process.

I can't emphasize how important that is.

Mr. **Nowak**. That's to get the source of funds when the business opportunity so dictates——

Mr. **Dennis**. Absolutely.

Mr. **Nowak**. Compared to over and over, the missed opportunity because of processing and so forth, and I would agree with you that that has the reliability factor, the constant factor. Even if the rate has a little differential, the room will still be sought after despite that differential.

Mr. **Dennis**. Yes, sir.

Mr. **Nowak**. I want to refer to an article that was published in the New York Times on October 11. The American Bankers Association held a banking convention in Honolulu, and Mr. John A. O'Leary, Jr., president of People's State Bank of Luray, Kans., was interviewed by the New York Times reporters. Incidentally, Mr. O'Leary was to testify here today except that he had an obligation and couldn't make it.

Because of his banking expertise, he was asked about the substantial effect on the local economy of the lifting of the ceilings on the interest rates that the banks may pay.

He comes out on a different side of this deregulation. He quotes very bluntly, but I think very correctly, at least in his area. He answers that problem with the lifting of the ceilings and the higher interest rates, but the question is, is this having a substantial effect on the local economy. His answer very bluntly is that this country was built on cheap money. The depositor subsidized the borrower. Now we've gone 180 degrees where the borrower is carrying all the freight, and the country is suffering.

I wonder what you experienced with your members in the last 1½ to 2 years as they've seen this change in the banking community.

Mr. **Dennis**. Well, it is no question that our members have seen their price of money just go out of sight, and that they have continually expressed a concern over the cost of money.

I must say that availability of money from 1974 on has not been a problem for most small businesses. There has been plenty of money. It's the cost of money, and there's no doubt that the borrower is now at least bearing his full load whether or not he's bearing a disproportionate share is something else.

Obviously as small businesses tend to be consumers of loans or consumers of credit, it's not in our best interest as a parochial thing to have loans priced at more than their true market value. On the other hand one has to look at the total perspective to see whether the depositers have an interest as well.

Talking Business | with John A. O'Leary Jr. of Kansas Bank

Rate Woes In Farm Belt

HONOLULU

Times are tough in the farm belt, especially for small farmers and their bankers. On top of the problem of getting repaid, many small banks are having to adjust to deregulation, which has driven up the cost of their funds. John A. O'Leary Jr. is close to many of these problems. Not only is he president and chief executive officer of the Peoples State Bank of Luray, Kan., which has $20 million in assets, but he also recently completed a one-year stint as the state's banking commissioner. Mr. O'Leary was interviewed at the annual convention of the American Bankers Association, which is being held in Honolulu.

Q. Have small banks such as yours been severely affected by the lifting of ceilings on the amount of interest banks may pay?

A. Yes. There's no more customer loyalty, even in a small town like Luray. This means we have to charge higher rates on loans to offset the higher rates we must pay.

•

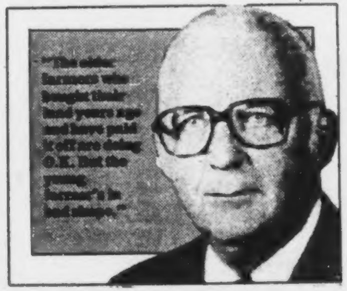
Q. Is this having a substantial effect on the local economy?

A. This country was built on cheap money. The depositor subsidized the borrower. Now we've gone 180 degrees, where the borrower is carrying all the freight, and the country is suffering.

•

Q. What does it mean for the farmers in your area?

A. The older farmers who bought their land years ago and have paid it off are doing O.K. But the young farmer's in bad shape. We break him as soon as we lend him some money. Say he needs $100,000. Our best rate now is 13.5 percent. The first $12,000 he earns he needs to feed his family. It costs at least $9,000 to operate 300 acres. Another one-third of his income goes to the landlord. If he gets 6,000 bushels of wheat out of that land, at $3.50 a bushel he brings in only $21,000. The equation just won't work. With 6 percent interest rates, he could make it.



•

Q. But is that feasible?

A. If I were to bet, we'll see reregulation within five years, not deregulation. They'll put interest-rate ceilings back, rates will come down and the country will prosper again.

•

Q. Over the long run, though, won't deregulation be good for banks?

A. No. We're going to have to protect the banks from themselves. We'll have what happened in the 1920's. Rate wars. The high cost of deposits will erode the bottom line and that will encourage banks to make more speculative loans. That's certainly what we don't need now.

•

Q. As you know, the list of so-called problem banks that is kept by the Federal Deposit Insurance Corporation is longer than ever. What factors, other than deregulation, are responsible for it?

A. There are an awful lot of people in banks who are not bankers, they're investors. They think the golden way to go is to buy a bank. When I was banking commissioner, I saw a lot of problems with insider loans to absentee owners. The bank should be a stable institution within the community and it should be run by people who care about the community. We're a public utility.

•

Q. Can't the regulators make sure the abuses don't happen?

A. Things are getting better now, but for a long time if the Federal regulators had a bank under a cease-and-desist order, they didn't enforce it. Sometimes banks were under cease-and-desist-orders for years and never had to do anything about it.

The trouble is, too often the regulators find out after the fact. You should have a way to license bankers. They should know something about the business before they get into it. People bought banks and used them as toys; they forgot it was depositors' money.

•

Q. What can be done with these troubled banks?

A. We're going to need a first-aid team for small banks. If a bank is big enough, there is more concern to help it, but they let small banks close. Most banks are savable. If you lose a bank in New York City, nobody knows the difference. But if you lose a bank in Russell County, Kan., everybody knows the difference.

•

Q. When you were banking commissioner did you try to deal with these problems?

A. Yes. I hired a guy who would go out to the troubled bank and live with it. That didn't work.

•

Q. Why?

A. I picked the wrong guy.

Robert A. Bennett

Mr. NOWAK. It's been stated that during the 1950's, 1960's and 1970's, in this country, we had a substantial growth because the interest rate had tracked the inflation rate somewhere above it at 2.25 to 2.75 percent through those years, and that gave the ability of the borrower to get into a small business or buy a home as Mr. O'Leary says, since it was perhaps subsidized to some degree.

Now the differential, as we see it, and Secretary Regan has stated, if the small business community is borrowing at 13.99 percent, you know, 9 points, 10 points, and that is the concern, how that will affect the expansion of small business, how that will affect the capital markets, and how they'll be able to compete?

Mr. OLIN. Will the chairman yield for just a second?

Mr. NOWAK. Yes, certainly.

Mr. OLIN. Is that a question along this line—you're implying that the interest rates being charged are beyond the true value. Could you expand on that a little bit more to philosophize a bit on how it got that way and just what you think from a policy standpoint is required to get that corrected?

Mr. DENNIS. $200 billion deficits don't make low interest rates.

Mr. OLIN. Is that the primary single factor?

Mr. DENNIS. Oh, I doubt whether it's——

Mr. OLIN. What other factors?

Mr. DENNIS. The single factor. If you get into larger questions one of the principal reasons that we do have interest rates as high as we do today is because depositors are getting their market value, whatever that market value is. That means that borrowers have to pay more than depositors are getting. If you look at it from strictly a supply demand sort of thing, a number of factors come immediately to the fore.

One of them is the $200 billion deficit. If the Government is borrowing $200 billion that means depositors have to purchase bonds or whatever you have, and if that occurs then you have a supply and demand situation which raises rates. Now, of course, the argument is, yes, but if the savings rate rises, then you won't have that problem.

That's true. Unfortunately, we're sitting within a 4-percent savings rate or something of that nature, and it looks like we're going to have maybe 5 next year. We're not like the Japanese who are in the double digit savings range.

Therefore, deficits do matter if I may take that particular side of the question. A second thing is I think merits concern. It's a very unusual thing for long-term rates to be higher than short-term rates. Now why are long-term rates higher than short-term rates?

To some extent it has to be that people are nervous. They really don't believe in the future. Why is that? Well, some of our previous experiences have not been helpful in instilling confidence. Again, to some extent we go back to the $200 billion deficit.

I am not a wizard. I've got no easy answers I am afraid, but it seems to me that that is one of the places to begin. I am not sure I answered your question.

Mr. OLIN. I think you did. You did very well. Could I ask one more question, Mr. Chairman?

Mr. NOWAK. Sure.

Mr. **Olin**. You said earlier in your testimony that small businesses are not paying 3 points over prime on the average, and they used to be right about at prime. You said prime is arbitrary, political figure. I didn't pick up how you related the interest rates small business is paying to say the Federal funds rate.

Mr. **Dennis**. Yes.

Mr. **Olin**. How has that varied over these same years?

Mr. **Dennis**. It hasn't varied with the extremes that the difference between prime and the small business rate has varied. There has been more constancy and consistency in it. Yes, I mean to some extent the prime is an artificial rate.

Mr. **Olin**. You don't see that same trend then, measuring the small business interest rate against a Federal rate, that is, a market rate.

Mr. **Dennis**. No, I am sorry. Yes, we do see the trend. It is just not as extreme. In other words using the prime as a measure has magnified the difference.

Mr. **Olin**. What's the difference between what the small business is seeing as compared to large business? Large business is the prime, I take it?

Mr. **Dennis**. Yes, is about the prime.

Mr. **Olin**. Yes, OK. Fine, thank you. Thank you, Mr. Chairman.

Mr. **Nowak**. Thank you, Mr. Olin. We had looked at this whole process of deregulation and I refer back to Mr. O'Leary's statement because here's someone who is in the bank community and seems to disagree totally with deregulation. In fact he says, and I am quoting again to an answer to a question, "If I were to bet, we'll see re-regulation within 5 years, not deregulation. They'll put interest rate ceilings back and rates will come down and the country will prosper again, which is what really was the hope of deregulation." You had mentioned the deficit, and I am just wondering, the Japanese rate of savings is substantially higher than the United States, and yet I understand that their deficit in proportion to their gross national product, is much larger than ours in the United States.

Some economists now have taken the position that the deficit does not relate directly to this, and yet others will still say we live in fear of rekindling inflation, and therefore, we must have a spread.

I am wondering if what has taken place in the economy, the condensing of our large industrial base, the pressure of wages, at least holding, or in some areas given concessions as you have with Eastern now and Braniff, and others, if that isn't a better indication of what inflation is going to do in the future rather than just merely looking at the deficit.

Mr. **Dennis**. Oh, yes. I didn't mean to give the impression that inflation, per se, was highly related to the deficit. It has to do with whether or not the Fed is going to finance it. It depends. My remarks were directed toward real interest rates. The entire question of the Japanese having a very large savings rate and also a very high deficit is one that some people tend to use as an example of how you can run a very high deficit yet maintain relatively low rates, low inflation rates and things like that.

Fine, but that is Japan, I think they have a 14 or 15 percent savings rate or something like that. We are 4, and that savings rate provides the pool from which borrowers can borrow. If there is no pool of savings then—or if there's a limited pool of savings, then automatically the supply demand has the effect of pushing that up. So if you can expand the pool of savings that is great. That is super. That's what we need to do.

That's one of the reasons behind paying the depositor the market rate. Still we're not going to have a 14-percent savings rate in the near future, and we have to recognize that.

Mr. Nowak. You know, I can remember 4 or 5 years ago we were discussing, on the House floor a budget deficit of some $25.9 billion or some figure like that. We were worried it was going to invade all the private markets and knock everybody out. I remember struggling for a series of what seemed like months to get it under $25 billion and call it $24.8 billion somehow, and hoping that would solve all the economic problems.

The cry was, at that time, too, that the deficit would hurt the whole economy if it got over $25 billion, and now 4 years later, we're looking at a $200 billion deficit.

Many say that we can take it this first year and roll it over, but I am wondering about the cumulative effect of that deficit if it does run in the terms that it is certainly progressing, even though some economists on the supply side say well, that's no great problem anymore, the deficit is secondary and won't have a substantial impact. There are others, as you know, within the administration who are encouraging Congress to wipe that deficit out this year and not even wait. Of course, there's a mixed opinion on that. As we're going through that whole procedure here we're going through continued deregulation. In 1986 you're going to have more deregulation, and one of the points that we've looked at is when we raise the savings bank passbook rates. When that rate comes off, and you get 5¼ percent accounts going into the mix of the cost of money—because that's what we're really dealing with now, it's a product with the bank. Even in that small area which I guess is about one-sixth to one-seventh of all their depository base now if their cost of money goes from 8 or 9 or 10 percent and mixes that higher rate, where in the economy is the pressure going to come from to knock that rate down? Are we going to have the bank going to the small business community saying, if you deposit money here we will pay you 6 percent.

It was very easy to say the banks will raise the rate and pay 8 percent if you put it in for 30 days, and 9 percent if you put it in for 6 months, but you know, how are we going to equate this and bring it back? What kind of deflator, I guess, could you see out there for the small business community?

Mr. Dennis. Well, it's an excellent question because first thing you can't do is to keep that ceiling on for just one particular type of account or particular type of bank, then why would any depositor put his money in there rather than someone else. So, you have the problem of various kinds of competing accounts, various rates of return that are out there. That creates a problem.

There are only two ways that it can be handled. One is that you have to have a greater supply of funds, which means people have to save more, or two, you can have less demand. There are only two places where you can have less demand. One is the private sector through a recession which isn't exactly a good idea as we've seen, and the other one is through the public sector.

There's no magic. I wish there were some magic. You can re-regulate. The third option is you can re-regulate the entire thing, but then there's some problems with that, too.

Mr. NOWAK. Mr. Williams?

Mr. WILLIAMS. I was going to ask you if you were in agreement with re-regulating.

Mr. DENNIS. The association doesn't have any position on that, so I will duck that if I might.

Mr. WILLIAMS. In your statement——

Mr. NOWAK. May I just interrupt? Has there been any real discussion on deregulation. I mean on re-regulation?

Mr. DENNIS. You mean within the organization?

Mr. NOWAK. Yes.

Mr. DENNIS. Not serious discussion. Our new president is a banker, and I have noticed he would like to discuss more banking issues than we have in the past. So I am quite certain that that will be an issue that we will discuss in the future.

Mr. WILLIAMS. The reason I ask that, in your statement, you mentioned that small business receives higher approval and lower interest rates with banks located in States where multibank holding companies were restricted, and most of the statements that I've interpreted you've made this morning would indicate that while you will not say it, that maybe you are looking in that direction, and I was wondering if——

Mr. DENNIS. I must be clear.

Mr. WILLIAMS. So your record is showing it as well as some of your——

Mr. DENNIS. Yes; apparently, I wasn't clear but when I said we have no position it is on the re-regulation of interest rates per se. We certainly do have positions on branching and things of that nature. Yes; we do have very strong positions. In the past we've opposed interstate banking, for example. The problem is that there have been enough loopholes in that particular law so that we get some very bad situations now developing.

I think we use the example of Prudential buying the bank in Hapeville, Ga. Because of the definition of a bank being an institution that takes deposits and makes commercial loans, obviously Prudential then can't buy a bank or can't operate a bank in the State of Georgia, so what they do is take deposits and forget about making commercial loans.

That isn't a very satisfactory situation, and that partially has come about by the restrictions on interstate branching. So, while we did not like interstate branching, we feel there has to be some clarification of some laws and regulations involved.

Mr. WILLIAMS. The other area of interest to me is the same thing I talked about in my other questioning with the other witness, and that's the attitude problem. Do you have anything that will show—I guess I am going to try to simplify this, the loan officer moving from a very small banking institution or S&L institution to a larger holding company, and seeing if his attitude changed, or if he is simply reflecting the policy of whatever entity he's representing?

Mr. **Dennis**. No, sir; we don't have any data. We assume that there probably will be a change, but we cannot prove it. We just would hypothesize that there is that difference.

Mr. **Williams**. I am concerned about attitude, but I think we might find that he is simply—or she is simply reflecting——

Mr. **Dennis**. Oh, yes, the policy of the bank.

Mr. **Williams**. It doesn't matter if he's known that—or she's known that small business individual for 30 years, and his or her record in the community. That bothers me a lot. I don't think it matters. I think it simply is a reflection of the entity that individual represents, so maybe it isn't as much an attitude as we think it is.

Mr. **Dennis**. I don't know, but it certainly is a question that's well worth looking at.

Mr. **Williams**. I represent Youngstown, Ohio, which is a very hard hit area as you know, Mahoning Valley, Ohio, and just the publicity that area has received, no loan officer or anyone in this Nation would be anxious to make a loan to a small business entity there, just given the reputation we have as a very hard hit area, and that's when we need it the most as you know.

Mr. **Dennis**. But whether or not that's a bank policy or the individual loan——

Mr. **Williams**. Don't the loan officers simply go by the ability to pay and——

Mr. **Dennis**. No.

Mr. **Williams**. Prospectus that they're given?

Mr. **Dennis**. No; they don't.

Mr. **Williams**. Why don't they?

Mr. **Dennis**. There's so much involved in a loan to a small business. The determination of the individual's character, and——

Mr. **Williams**. They make a small business do more than they would make a major corporation because there's usually a personal signature involved.

Mr. **Dennis**. Well, when a small businessman goes into a bank for a loan, they not only evaluate him on the paper that's there. They certainly look at that. Don't get me wrong. I don't mean to say that they're not interested in that.

Mr. **Williams**. But why do they go beyond for a small business individual?

Mr. **Dennis**. Because the business itself is so contingent upon that individual. The success or the failure tends to rest with that individual, in his management capacity, and his own personal attributes. A very large corporation frequently can pitch the president, and no one is going to miss him. You know, it's a big sort of thing.

In my discussions with bank loan officers and bank presidents and things of that nature, they place a very high premium on the individual. That's one of the reasons why I think that the attitude and the knowledge of the loan officer is critical, and why I become concerned when a heavily branched bank comes in and starts moving their loan officers out.

Mr. **Williams**. Well, I'll talk to some of the bank representatives about it. It's puzzling to me sometimes. Thank you very much.

Mr. **Dennis**. Thank you.

Mr. **Nowak**. Mr. Vandergriff, Texas.

Mr. **Vandergriff**. You indicated, sir, that the federation didn't have a position on re-regulation if I can term it——

Mr. **Dennis**. Of interest rates.

Mr. **Vandergriff**. Yes; do you have a position on whether banks should be allowed to sell insurance?

Mr. **Dennis**. Yes, sir.

Mr. **Vandergriff**. Deal in real estate?

Mr. **Dennis**. Yes, sir. We don't think that's a particularly good idea. The reasoning behind it is that it's a conflict of interest, and the bank would enjoy considerable leverage that other types of independent businesses wouldn't have.

Example, homeowner goes in to borrow money for a home. The bank suggests that perhaps they would like to purchase their insurance there, or they would like to actually go through that realtor. Now, the bank could be as innocent or as up and up as they possibly can be in separating these functions, but to the borrower that perception just doesn't fit.

We can talk about consuming credit as if we were consuming anything else. In other words we can talk about borrowing money or purchasing money like purchasing food from a grocery store. It's just a different kind of product. That's the theory. That is not the practice. As a practical matter, we think of money differently than we do other commodities. I think we find ourselves in a situation where there's an implicit, if not an actual, threat of denial of funds if you don't buy other products.

Banks are unique. Our financial institutions are unique, and ought to stay that way.

Mr. **Vandergriff**. All right, sir. Thank you very much. Thank you, Mr. Chairman.

Mr. **Nowak**. Thank you, Mr. Dennis. We have your whole testimony and all the reports that you have alluded to. All of those will be incorporated in the record.

Mr. **Dennis**. Thank you. Mr. Chairman, I would like to indicate this is a product of two studies done in 1980 and 1982. In 1984 we will update it again, so we will then have 6 years running, and would be happy to provide it to the committee.

Mr. **Nowak**. Fine. We won't keep this record open till 1984. [Laughter.]

I want to indicate our strong respect for your expertise, and the work that the NFIB has done in this area. It's been very helpful to us, and I think to the other Members of Congress to focus on these types of problems.

There's going to be, I think, great discussion as deregulation goes forward, and I am sure you'll be in the forefront of that discussion with your members as the feedback starts to come in, and the different phases of deregulation go through.

As to the extent that commercial powers for banks can be competitive along with the rate changes, things that are going to have vast important changes for the small business community are such new options as so-called nonfinancial institutions now collecting deposits, if you will, even though they're termed something else for other purposes. We want to stay on top of that as nearly as we can, and make sure that those effects are at least well known.

Again we want to thank you for your terrific detailed testimony, and I'm sure we'll be back to you with other questions as we conclude this hearing and this report.

Thank you very much.

Mr. **Dennis**. Thank you.

Mr. **Nowak**. Our next witness is from the Independent Bankers Association of America. We have representing that organization James R. Lauffer, who is the president of First National Bank of Herminie in Herminie, Pa. Mr. Lauffer is also testifying on behalf of the 78-member association of the Small Business Legislative Council.

He has been in the banking business for over 20 years, is very active in community affairs, and has been a member of the business committee advisory board at Westmoreland Community College.

He is also past president of the Independent Bankers Association in Pennsylvania. We want to welcome you, Mr. Lauffer, and again, just state for the record that your full text will be incorporated, and you may proceed as you so desire.

TESTIMONY OF JAMES R. LAUFFER, PRESIDENT, FIRST NATIONAL BANK OF HERMINIE, PA., ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA, AND THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. **Lauffer**. Thank you, Mr. Chairman. I appreciate this opportunity, and I want to compliment you and your committee on the perception of the problems that are out there. The things I've heard this morning are a fantastic indication of what grasp there is of the problems you're looking at.

I am president of the First National Bank of Herminie, Pa. We're 23 miles east of Pittsburgh. We're right off the Pennsylvania Turnpike. It is a $76 million bank with four offices. There are 14,000 commercial banks in the United States, and we rank about 3,200.

In other words there are 11,000 banks that are smaller than we are, so this illustrates the point that community banks are small business. We employ about 60 people. Those 11,000 entities out there that are smaller than we are, are definitely small business.

I am testifying today on behalf of the Independent Bankers of America which has approximately 7,000 members of which most are small- and medium-size commercial banks located in the smaller towns and suburban communities across the United States.

Our members make the major share of commercial loans to small business and to agriculture. I am also testifying on behalf of the 78-member association of the Small Business Legislative Council, whose members jointly represent nearly 4.5 million small business units.

The relationship between local banks and small business is a close one, based on mutual business interests. The banking industry supplies the overwhelming proportion of outside capital to existing small businesses in the United States.

Recent survey by the Interagency Task Force on Small Business found that approximately one-third or $119 billion of $358 billion outstanding loans at 10,309 commercial banks on June 30, 1981 were to small business.

Various surveys have been done, and small business people point out that it is to their advantage to deal with a local independently-owned bank. For instance, responses to an October 31, 1981 SBA questionnaire which was responded to by 2,000 small businesses indicated the following:

> More than two-thirds of the respondents believe that the size or location of the bank affects its willingness or ability to meet the respondent's credit needs. Half of these respondents provided additional information. More than two-fifths said they prefer to deal with a local bank (with no mention of size), while another two-fifths prefer a small bank and less than one-fifth a large one. A third of those expressing their preference in terms of bank size also mentioned convenience of location.

We're in the Pittsburgh market, the next county to Pittsburgh, and within a 5-mile radius of my 4 offices there are thirty some financial institutions.

My area includes the Mellon Bank, 13th largest in the Nation before they merged with Gerard and had a couple other mergers, Pittsburgh National Bank, the Union National Bank of Pittsburgh, and Equibank. At these major banks, I don't think it's the attitude of loan officers as such. It's simply the policy coming down from above. Twenty-five years ago when I started in our particular bank, we had about 30 independent banks in our county.

We're down to five now, and you can see the sway in our particular county as policy from the Pittsburgh banks comes down on what kind of loans they want to make at any particular time.

We watched the court record regarding residential type mortgages, and in the court record just this last month one of the majors in Pittsburgh made 16 mortgages. They have something like 12 offices in the county, compared to 2 or 3 of the locals who made 15 to 18 mortgages in the same time period. So it's not the personalities so much. It's the policy. Then you get the fact with branch managers, we've competed against Mellon Bank, Pittsburgh National, as I mentioned. I've seen 10 or 12 branch managers over the 25-year period, and that's where we make our mark, because we are there.

The president of a locally owned community bank, I think statistics will prove, has been there. He knows the business. He knows the people. These branch managers move in and out, and all they have is the standard operating procedure of what they're supposed to do. Not their fault, but when the policymaking is not there in that community, there is a difference.

The basic reasons for small businesses preferring to deal with a local bank are well known. What a small businessman wants is a personal relationship in which the bank understands the basics of his business.

Another 1983 survey by NFIB on "Credit, Banks, and Small Business," documented the situation. It summarizes the results and the most important aspect to a small business relationship. "Knows you and your business" was the most frequently mentioned factor, and you can't have that with transition in and out.

You can't do as good a job with that because it takes a while to learn a person and learn the business.

However, it's not enough that the local bank and small business have a working relationship which makes good business sense to both parties. It is also essential that financing remain available to small business through local banking firms at affordable rates. That is where certain aspects of banking deregulation are seriously jeopardizing the future of both community banks and small business borrowers.

We're in the process of three types of deregulation, Mr. Chairman. One is interest rate deregulation, two is product deregulation, and three is geographic deregulation.

I am not advocating that we turn the clock around on interest rate deregulation. There would be a lot of problems there, but my opinion is that consumers and the public may demand re-regulation within a 3- to 5-year period if we don't have a stabilization of credit available at cheaper rates, and I am not sure that that will be accomplished under the situation we have.

With regard to interest rate deregulation, the highly respected chief economist of the First Boston Corp. wrote the following to his clients on August 4:

> The economic upsurge was launched when short-term rates were over 8 percent and long-term rates were above 10 percent, while the CPI was flat. Unemployment was 11 percent, and many banks and companies were in financial distress. For a strong economic recovery to begin in these circumstances suggests that 8 or 9 percent is a kind of zero base from which interest rates are to be measured. These permanently higher interest rates are a product of interest rate deregulation.

I fully agree with that. The saver has subsidized the borrower in this country, and the country is built on houses and cars and cheaper money to obtain houses and cars. With deregulation of interest rates, money has floated to the highest rate, and the community banks have had to pay the competitive rate in their particular area or more to get the money.

Therefore, the borrowing cost has to go up. It is surprising sometimes to see how people disassociate wanting the most they could get on deposits with the borrowers wanting the least they can pay on loans. As another speaker mentioned, there has to be a 2- to 3-percent spread there. There's not going to be any other way, so if we're going to have lower rates on loans, we must have lower rates on deposits.

Mr. **Nowak**. Could I just interrupt your statement?

Mr. **Lauffer**. Sure.

Mr. **Nowak**. You made this point about the interest rate. There has to be a 2- to 3-point spread. As you're talking about product deregulation and geographic deregulation isn't it possible, as some have stated, that a supermarket agency may not have to operate with a 3-point spread to be profitable in an area if they don't have the same type of overhead so to speak, with branch offices and parking lots and electricity and heat and desks and personnel and other expenditures by individual banks. Do you see this as a change of that trend?

If, in fact, a supermarket made dollars another aspect of their operation, when the money market funds started to come in, they would find themselves at a tremendous disadvantage. In this case, they are not playing by the same deposit versus security rules, and conversely, they would be forced to operate with the liability of deposit versus the requisite overhead expenses for the same type of transaction. Your deposit base is going to change dramatically, but I would assume that the depositors want the highest interest rate allowable and at the same time, want to borrow the money at the lowest rate available.

Mr. **Lauffer**. That's exactly right.

Mr. **Nowak**. Where does that put your kind of organization?

Mr. **Lauffer**. Yes, well getting back to the point you made about the supermarket and the near bank, you're right: costs are different, capital requirements are often lower, insurance on deposits may not be there, so they're playing under a different ballgame than the banks are playing.

Ours has to be a more costly situation given the capital requirements and the deposit insurance requirements.

Mr. **Nowak**. Thank you.

Mr. **Lauffer**. According to the October 9 New York Times, economists estimate that the higher cost of bank funds resulting from deregulation probably has raised the general level of interest rates about 1½ percentage points. Another indication of the continual harmful effect of high interest rates on small business is the fact that the SBA's scaled back $2.5 billion in business loan guarantee program is winding up fiscal 1983 with $400 million of unused lending authority.

With regard to the second dimension of deregulation, the geographic deregulation, we're witnessing the steady erosion of structural and legal safeguards against national concentration in banking and money markets in the United States.

Unless we put real substance back into Federal law which was designed to sustain the dual banking system in the United States, the reality of local money markets serving local business units may not survive. I think we see this today with brokered deposits all over the country.

Interstate banking in some cases has already been accomplished on the deposit taking side, and when that money flows to another section of the country or to a foreign country for a higher rate of return, it's coming out of the local market. There's no other way to look at it, and with centralization, bigger banks, bigger financial institutions controlling, that money is going to go where it's going to get the biggest return.

We see that right now in western Pennsylvania. I am sure Mr. Williams has seen the papers of large banks in Pittsburgh, complaints from consumers and steel workers that their money is being spent other places, and that is a business decision.

Small community banks' business decisions have to be made with the best interest of the community at heart because that's our business. We're small business, too, and if we are going to stay there, we've got to respond to the needs of those people. Large institutions really don't have to do that.

They give lip service to do that and they do it sometimes, but if opportunities allow money moves across seas, across the United States. Federal law reserving final authority with the State legislators on interstate banking and deposit taking has the purpose of sustaining independent community banks within the banking structure.

This legal arrangement also serves the borrower's purpose of sustaining local financial intermediaries and the local money markets which are important and perhaps essential for decentralized small business to survive and prosper in this country.

On this broader front, I find it encouraging that IBAA has joined this year with 77 other small business groups representing nearly 4.5 million small business units through the Small Business Legislative Council to adopt the following policy on localized capital markets:

> SBLC supports the maintenance of vital, local capital markets throughout the United States, in which mutually reinforcing financing relationships between small business and independent community banks can thrive. To maintain local capital markets, we urge Congress and the administration to reaffirm support for Federal statutory law which places geographic limitations on bank branching and holding company affiliations, at least until new laws and regulations are established which can assure a continued decentralized small business (including banking) structure in the United States. We do not think that general antitrust policy is adequate to achieve this result.

As mentioned before, it would be very hard to turn the clock back on interest rate deregulation, but geographic deregulation could be stopped until we see where we're going, what problems small business will have, and how many community banks will be left.

No one is going to be hurt by slowing down the deregulation we've already had, rather than going full strength ahead, in which case 2 years from now, two parts of it might have been right and the other part wrong which defeats the whole thing.

Mr. Chairman, adopting and pursuing the policy within the Small Business Legislative Council we've not blinded ourselves to the fact that there is rampant circumvention of the bank structure laws, which, if it goes unchecked, threatens to totally undermine local money markets and local financial intermediaries over the next few years.

More important, however, we're not resigning ourselves to the self-delusion that we might write off these legal safeguards as a lost cause and expect to hold some ill-defined line between financial and business concentration, which would keep small business and independent banking sectors viable in the United States.

For this reason we dare not give up on the Federal banking structure statutes, and we recognize that broader public attention must be brought to bear on the long-term national importance of the issues involved.

This hearing today is very useful in promoting that kind of broader public attention, and we would encourage you and your colleagues on the Committee on Small Business to devote the maximum possible attention to these issues.

I would add a couple of other things. When interest rates went to 21 percent prime, nationwide, our bank and most of the community banks never approached 21 percent on our small business borrowers.

The maximum our bank got to was 18 percent, and that wasn't loans that were on the books. That was new loans we were making when the market was 21 percent prime. Loans that were on the books, as prime moved some 50 times within the period of a year, might have been taken from 11 percent to 14 percent.

I think 14 percent was the maximum we ever went with loans on the books, and that kind of thing is being taken away from us with deregulation. A businessman cannot expect to get a fixed-rate loan anymore because our deposits, most of our deposits now are in the new money market funds. Our rate changes each week, so if our rate changes the borrower's rate has to change, and that doesn't provide much stability for him in a business where his payment may change each month because his interest rate changes.

Although community banks across the country never got to 21 or 22 percent, you can bet that the large money center banks got there. I can guarantee that.

If you reduce the numbers of players, somewhere along the line you have to have less competition. You may have two big banks fighting with each other for the big loans, which are unit costwise as was stated before, cheaper to put on the books.

It is just as cheap to put a $5 million loan on the books as it is to put a $25,000 loan on the books. You've got to service that $25,000 loan, with payments each month or quarterly or whatever, the same way as a $5 million, but your return on the $5 million certainly is much greater.

To get the $5 million, you'd have to make how many $25,000 loans? So, there is a difference in cost, and that's why major banks would rather put on large loans. It's only an economic reason why they would rather put on large loans. That concludes my testimony, Mr. Chairman.

[Mr. Lauffer's prepared statement with attachment follows:]

PREPARED STATEMENT OF JAMES R. LAUFFER, PRESIDENT, FIRST NATIONAL BANK OF HERMINIE, PA., ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA, AND THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. Chairman and members of the Subcommittee, I am James R. Lauffer, President of the First National Bank of Herminie in Herminie, Pennsylvania. I am testifying today on behalf of the Independent Bankers Association of America, the approximately 7,000 members of which are mostly small and medium-sized commercial banks located in smaller towns and suburban communities across the United States. Our member banks make the major share of their commercial loans to small business and agriculture.

I am also testifying today on behalf of the 78-member associations of the Small Business Legislative Council, whose members jointly represent nearly 4.5 million small business units covering almost the full range of the SIC classification. A statement of the SBLC's position on issues related to this hearing is attached.

The relationship between local banks and small business is a close one, based upon mutual business interests. The banking industry supplies the overwhelming portion of outside capital to existing small businesses in the United States. A recent survey by the Interagency Task Force on Small Business Finance found that approximately one-third (or $119 billion) of about $358 billion of total business loans outstanding at 10,309 commercial banks on June 30, 1981, were small business loans.

Attitudinal surveys repeatedly show that, among bank lenders, small businessmen find it advantageous to deal with local, independently-owned banks. For instance, response to an October 31, 1981 SBA questionnaire, to which approximately 2,000 small business firms responded, indicated the following regarding their banking preferences:

"More than two-thirds of the respondents believe that the size or location of a bank affects its willingness or ability to meet the respondent's credit needs. Half of these respondents provided additional information. More than two-fifths said they prefer to deal with a local bank (with no mention of size), while another two-fifths prefer a small bank and less than one-fifth a large one. A third of those expressing their preference in terms of bank size also mentioned convenience of location."

The basic reason for small business preferring to deal with a local bank is well known. As a New York Times article stated last year, ". . . what small-business men want are personal relationships in which the banker understands the basics of the business." The May 1983 survey by NFIC on "Credit, Banks and Small Business," again documented this situation. In summarizing their survey results on "the most important aspects in a small business banking relationship," the NFIB reported that " 'Knows You and Your Business' was most frequently ranked very important (67 percent in both surveys), followed by 'Reliable Source of Credit' (55 percent)."

However, it is not enough that local banks and small businesses have a working relationship which makes good business sense to both parties. It is also essential that financing remain available to small business through local banking firms at affordable rates. And that is where certain aspects of banking deregulation are seriously jeopardizing the future of both community banks and their small business borrowers.

With regard to interest rate deregulation, the highly-respected chief economist of the First Boston Corporation wrote the following to his clients on August 4:

"The economic upsurge was launched when short term rates were over 8 percent and long-term rates were above 10 percent, while CPI was flat. Unemployment was 11 percent and many banks and companies were in financial distress. For a strong economic recovery to begin in these circumstances suggests that 8 or 9 percent is a kind of new zero base from which interest rates have to be measured. *These permanently higher interest rates are a product of interest rate deregulation.* (Italics added for emphasis.)

According to the October 9 New York Times, "Economists estimate that the higher cost of bank funds (resulting from deregulation) probably has raised the general level of interest rates by about 1½ percentage points" (p. F29). Another indication of the continuing harmful effect of high real interest rates on small business is the fact that even the SBA's scaled-back $2.5 billion 7(a) Business Loan Guarantee Program is winding up Fiscal 1983 with about $400 million of unused lending authority.

With regard to a second dimension of deregulation—geographical deregulation—we are witnessing the steady erosion of structural and legal safeguards against national concentration in banking and money markets in the United States. Unless we put real substance back into Federal statutory law which was designed to sustain the dual banking system in the United States, the reality of local money markets serving local business units may not survive.

Federal law reserving final authority with the state legislatures on interstate banking and deposit-taking has the purpose of sustaining independent community banks within the banking structure. This legal arrangement also serves the broader purpose of sustaining local financial intermediaries and money flows—that is, local money markets—which are important and perhaps essential for decentralized small business to survive and prosper in this country.

On this broader front, I find it encouraging that the IBAA has joined this year with 77 other small business groups, representing nearly 4.5 million small business units through the Small Business Legislative Council, to adopt the following policy on "Localized Capital Markets":

"SBLC supports the maintenance of viable local capital markets throughout the United States, in which mutually reinforcing financing relationships between small business and independent community banks can thrive. To maintain local capital markets, we urge Congress and the Administration to reaffirm support for Federal statutory law which places geographical limitations on bank branching and holding company affiliation, at least until new laws and regulations are established which can assure a continued decentralized small business (including banking) structure in the United States. We do not think that general antitrust policy is adequate to achieve this result."

Mr. Chairman, in adopting and pursuing this policy within the Small Business Legislative Council, we have not blinded ourselves to the fact that there is rampant circumvention of the bank structure laws which, if it goes unchecked, threatens to totally undermine local money markets and local financial intermediaries over the next few years. More importantly, however, we are not resigning ourselves to the self-delusion that we might write off these legal safeguards as a lost cause and expect to hold some ill-defined line against financial and business concentration which would keep small business and independent banking sectors viable in the United States.

For this reason, we dare not give up on the Federal banking structure statutes, and we recognize that broader public attention must be brought to bear on the long-term national importance of the issues involved. This hearing today is very useful in promoting that kind of broader public attention, and we would encourage you and your colleagues on the Committee on Small Business to devote the maximum possible attention to these issues.

I. RESOLUTION OF SMALL BUSINESS LEGISLATIVE COUNCIL

Localized capital markets.—SBLC supports the maintenance of viable local capital markets throughout the United States, in which mutually reinforcing financing relationships between small business and independent community banks can thrive. To maintain local capital markets, we urge Congress and the Administration to reaffirm support for Federal statutory law which places geographical limitations on bank branching and holding company affiliation, at least until new laws and regulations are established which can assure a continued decentralized small business (including banking) structure in the United States. We do not think that general antitrust policy is adequate to achieve this result.

II. BACKGROUND PAPER ON RESOLUTION

The following sections of this paper briefly discuss: (1) the importance of the relationship whereby local banks finance small business; (2) why maintaining localized money markets is essential for that relationship to continue; and (3) why maintaining and enforcing Federal limitations on interstate deposit-taking is necessary to sustain local money markets.

I. RELATIONSHIP BETWEEN LOCAL BANKS AND SMALL BUSINESS

The banking industry supplies the overwhelming portion of outside capital to existing small businesses in the United States. A recent survey by the Interagency Task Force on Small Business Finance found that approximately one-third (or $119 billion) of about $358 billion of total business loans outstanding at 10,309 commercial banks on June 30, 1981, were small business loans. Since small business' access to equity markets is quite limited, these loan funds represented the major source of small business finance other than retained earnings of small business enterprises.

Attitudinal surveys repeatedly show that, among bank lenders, small businessmen find it advantageous to deal with local, independently-owned banks. For instance, responses to an October 31, 1981, SBA questionnaire, to which approximately 2,000 small business firms responded, indicated the following regarding their banking preferences:

"More than two-thirds of the respondents believe that the size or location of a bank affects its willingness or ability to meet the respondent's credit needs. Half of these respondents provided additional information. More than two-fifths said they prefer to deal with a local bank (with no mention of size), while another two-fifths prefer a small bank and less than one-fifth a large one. A third of those expressing their preferences in terms of bank size also mentioned convenience of location." [1]

The primary reason why the vast majority of small businessmen prefer to deal with a local community bank was stated in a recent New York Times article: ". . . what small-business men want are personal relationships in which the banker understands the basics of the business." [2] The relationship in which the local independent banker has a good understanding of the business owner-operator and of his business, and therefore can make credit decisions on a timely and dependable basis, is often contrasted with banking through a branch of a larger banking system where the branch manager may be unable or unwilling to make loan commitments and may be transferred away from a small business client before any workable business relationship between borrower and lender has time to develop.

From the local bank's perspective, local distributors, retailers, and other small businesses are valued as customers. While large, high-volume banks tend to view small business loans as risky and costly to administer, the community bank whose returns derive from adding substantial value to a lower volume of business generally views small business lending as a major element in its operations. Further, in most instances small business' credit requirements are within the lending limits of independent community banks. According to the survey by the Interagency Task Force on Small Business cited above, loans with an original balance of $100,000 or less made up 84 percent of all business loans by banks with less than $100 million of assets and 80 percent of business loans by banks in the $100–$500 million assets category.[3] Thus, the average size small business loan can be accommodated by an independent bank without a Federal guarantee or other means of extending the bank's legal lending limit.

---

[1] *Studies of Small Business Finance,* A Report to Congress prepared by the Interagency Task Force on Small Business Finance, February 1982, P. 37. See also, E. Peter Gillette, Jr., "Banking's Commitment to Small Business," *The Journal of Commercial Bank Lending,* June 1982, p. 5.

[2] "How the Banks Are Squeezing Small Business," New York Times, April 25, 1982.

II. WHY LOCAL MONEY MARKETS ARE ESSENTIAL

It is not enough that local banks and small business have a working relationship which makes good business sense to each of them. Another essential factor is that funds generated in the local community should remain available for recycling within the community so that the mix of deposit-taking and lending benefits the local economy. Otherwise, if money center banking institutions were allowed unrestricted access to attract funds out of local communities for investment elsewhere, the funds deposited by local businesses would wind up financing the nationwide retailing and distribution chains and other big businesses with whom local businesses must compete.

III. LIMITING INTERSTATE DEPOSIT-TAKING

If local money markets are essential in order for the functional business relationship between community banks and small businesses to survive in the present era, then it is necessary to maintain effective limitations on interstate deposit-taking by depository institutions. General anti-trust policy is inadequate for this purpose.

In a sense, legal limitations on the gathering of deposits on an interstate basis in regard to banking structure can be compared with the Robinson-Patman Amendments to section 2 of the Clayton Act. It has been said that the Robinson-Patman Act reflected an *anti-trust* purpose of preserving a competitive system, and a *supplementary* purpose of protecting independent retailers, distributors, and other local firms from unfair pricing competition on the part of concentrated business chains. In a roughly similar sense, Federal law reserving final authority with the state legislatures on interstate banking and deposit-taking has the purpose of protecting independent community banks within the banking structure. In this latter case, the Federal policy affords a measure of protection to independent banks as small businesses, but it also serves the broader purpose of sustaining local financial intermediaries and money flows that are important and perhaps essential for decentralized small business to survive and prosper in this country.

Of course the Robinson-Patman Act and the Federal limitations on interstate deposit-taking have another thing in common: both have been imperfectly administered and partially circumvented by those players in the market who would profit from their demise. However, in view of the enormous values at stake, our response in both instances must be to work for effective enforcement of the law.

Mr. **NOWAK**. Thank you very much. I think you've put in perspective what the Independent Bankers of America have said—where they position themselves on future deregulation especially in the geographic area that is probably just starting to expand throughout the country.

I am wondering if you've talked with anybody in the administration about the deregulation issues, and if you've had any response from the administration?

Mr. **LAUFFER**. I am sure we have. The response seems to be that everything is pushed toward deregulation totally, that this is going to be the best for the consumer, for the public. I don't think they've been able to prove that.

The position is, when you talk about stopping the speed of deregulation you don't want competition. I can tell you that I compete everyday, and if the playing field is level, we can compete against Mellon, Chase, whomever. But if the playing field regarding capital requirements and some of the other reasons is not level, then it's going to make it very difficult. And if we have to pay New York City market rates when Citibank comes into Pittsburgh, if we have to pay that to our customer, then what we'll have to do instead of loan it to the local community would be take our deposits and buy some investment perhaps elsewhere.

---

[3] *Studies of Small Business Finance*, p. 60.

Do we lose for a period of time hoping interest rates are going to reverse themselves, or put someone out of business by giving him a 21-percent loan?

Mr. **Williams**. But you see, I think what you're saying is what I am believing, and I have no experience in the banking industry, but what you're doing is going beyond the bottom line and the numbers that you're looking at simply because you're committed to that community.

Mr. **Lauffer**. But with total continued deregulation, as it is, we would probably have to change that. And it's going to impact on them, because we used to make all fixed rate business loans. Therefore, the business could look at their cash flow for 5 years and know what their payments are going to be 3 years to 5 years.

Now they can't do that, and we can't do that.

Mr. **Williams**. Do you feel the variable rates have contributed to the somewhat high number of bankruptcies in your area?

Mr. **Lauffer**. I think that it's definitely a factor.

Mr. **Williams**. Even though they can plan better than they could plan before because they couldn't get loans at all.

Mr. **Lauffer**. If you get it, the rate may be too high to afford it. The money is there to get right now. Everybody has money to lend. It is just a question on how it is lent and what position you're putting that borrower in. It's the same way with the consumer fixed-rate mortgage.

It's a different ball game.

Mr. **Williams**. I appreciate your testimony.

Mr. **Lauffer**. Thank you.

Mr. **Nowak**. Mr. Vandergriff.

Mr. **Vandergriff**. Mr. Lauffer, I'd just like to give you equal time with the National Federation of Independent Business. Do you think banks have the right to sell insurance, sell real estate, deal in real estate.

Mr. **Lauffer**. Well, there are a lot of different opinions there. With my bank at $76 million, I don't think at this point we have the expertise to be in a situation that we know nothing about. We saw big banks move into the real estate trust back in the 1970's. They knew very little about them and they lost a lot of money. So personally I'd say a lot of the community banks won't desire to get into those areas, but with the pressure on the spread that you can get on a loan or an investment, you have to get fee income if you are going to stay in business. Therefore, all your service charges have to be increased, and every avenue of other outside income has to be put in place, because an adequate spread on loans and investments is not there to carry you. So, community banks are going to be forced into other activities as a business decision to create more fee income through the bank.

Mr. **Vandergriff**. All right. Thank you. Thank you, Mr. Chairman.

Mr. **Nowak**. I just want to acknowledge your testimony has covered an awful lot of areas including the antitrust area which I think, will be the target of further discussion as the effects of deregulation become more prominent.

In your opinion what happens when money becomes tight again if the scenario is allowed to play out?

Mr. **Lauffer**. I think you're going to see money moved to different parts of the country, and you're now seeing some institutions broker money from one section of the country to another. They had loan demand of one respect or another, so they went through national brokers and picked up deposits out of Pennsylvania, West Virginia, Ohio, New York, whatever, and took the money to the Southwest or wherever they had loan demand and paid a higher rate. The money flew out.

I think that's what they're going to see. Money will fly all over the place until there are substantial failures. The problem with the brokered money is that people in Pennsylvania, when they hear about a shaky situation in California or Texas or wherever and they've got money there, will want their money back.

Then this puts a strain on that institution and that area to come up with replacement deposits to cover loans already made. If this continues, certain places will be shut out of the credit market. The money will go to where it brings the highest interest, until the demand swings back the other way.

Mr. **Nowak**. Well, you may have problems within your community, but is there a potential swingback to make a market correction? Will that come in time to support the small business capital demand loan in those areas. You know, trying to reach the effect of the whole circle.

Mr. **Lauffer**. It may come too late.

Mr. **Nowak**. Isn't it true that when you talk about the 18-, or 19-, or 21-percent jump that a lot of so-called small businessmen, who started out those loans at an 8- or 9-percent investment, and the rates went from that 9-percent position to 18, to 20, that they could not continue with expansion or could not make the commitment of those dollars to pay the loans back at that rate? That plus the recession is why you had a tremendous increase in small business failures over the last 2 or 3 years, and I am wondering with the structure of the adjustable rate mortgages and with all of the other variable rates that are now really the standard in the industry, if we have a swing up again, we're going to see the same phenomenon of the squeeze between the differences in what they're paying now and what they could be paying. As you say, if this goes interstate, and the money starts swinging out in large numbers, and they're requested either to pay the rate in southern California, or in your Franklin County, Pa., or face loss of money, they will have to go to another institution around the State, and try to borrow money, but not at the rate that they had forecasted.

Mr. **Lauffer**. That's exactly right. Mr. Chairman, that is the scary thing about concentration as we let financial institutions or any institutions get so big. AT&T is being broken up. In one respect, we're saying it got too big. In another respect, we're fostering regs and laws that are going to allow the financial industry to do the same thing.

I think there's a definite problem there.

Mr. Nowak. Well, in all this competition for money, I guess, you know the worst case scenario we've seen is where you had the banking community, if you will, paying and receiving high interest rates from some of our friends in the oil business. They transferred large sums of money from different areas to support those oil investment loans, and then when that turned and the price of oil did not go from $38 to $70 but rather from $38 to $28, all of those large bank institution problems became very evident. Of course, the failures that transpired after that was probably a lesson well learned by a lot of institutions.

I would think that your scenario of that money going to the highest rate of return is going to happen regardless of the so-called prudent risk out there. Perhaps in search of that highest rate that risk becomes manageable and somewhere down the line we'll have a recycling of that same procedure.

Mr. Lauffer. Mr. Chairman, if we foster the laws and the regs for geographical concentration, allowing some real superinstitutions, what do you do when one of those fail as you had out in Washington State with Seafirst. In Arizona, for example, three banks have 97 percent of the market, and when you look at their annual report, you see they have maybe 28 or 30 directors. Therefore, about 75 people are making most of the credit decisions on the allocation of credit across that State. You might have that same thing developing across the Nation, and you do in some respects right now.

That to me is frightening, because I really don't think these people in some central location appreciate the 18- to 20-percent unemployment that we've had in our area.

Mr. Nowak. Well, I want to thank you very much for your testimony, and certainly for taking the time to appear and put it in the record, which we hope will be widely distributed. As we go through the next year, I think we will find the implications are great and certainly the operations of small community banks will be changing very, very rapidly. It's good to know that you are involved with the subject and able to give us your opinions and tell us what's happening in the real world out there.

We wanted to just inform you that we're going to hold this record open, and if we need further information, you can submit your answers to the questions in writing.

Mr. Lauffer. Thank you very much for the opportunity.

Mr. Nowak. Thank you very much.

Our next witnesses are from a little different sized institution, namely Chemical Bank, and if they'll come forward we have Bill Mooney, who was recently promoted to senior vice president. Mr. Mooney has been with Chemical since 1970, and functioned as a division head in various capacities including the commercial lending division. We also have Bill Wulfing, who is vice president and director of the small business unit for the bank, and he's been with Chemical since 1974, and was recently appointed to the American Bank Association's National Committee on Small Business. We know the work they've done on the past on this subject, and we welcome the opportunity to hear from these two witnesses once again.

TESTIMONY OF WILLIAM M. MOONEY, SENIOR VICE PRESIDENT, CHEMICAL BANK OF NEW YORK; ACCOMPANIED BY WILLIAM H. WULFING, VICE PRESIDENT AND DIRECTOR OF SMALL BUSINESS, SMALL BUSINESS UNIT

Mr. **Wulfing**. Thank you, Chairman Nowak and distinguished members of the committee, for offering Chemical Bank this opportunity to address you on some serious issues affecting small business.

May I say that Bill Mooney and I do speak from a different perspective than has been offered by the other parties testifying this morning in that we are not an association or organization representing a group. We're here today to speak as two bankers working in one large bank that has a very special interest in small business; so, my colleague, Bill Mooney, and I would like to briefly discuss three subjects.

First, deregulation and small business loan rates.

Second, highlights of a recent survey which we conducted and which you have a copy of, "Small Business Speaks: the Chemical Bank Report," and

Third, Chemical's program to guarantee that small businesses in the New York metropolitan area receive the credit and financial services that they need.

We remember well the time so recently when the mutual money market funds had drained billions from commercial banks and small businesses were faced with the debilitating and potentially destructive combination of both extremely high loan interest rates and inadequate credit availability.

Today, we, both the bank and the small business customers, are in the significantly more desirable position of a lower loan rate environment, and with the return of the money market deposits due to deregulation, there is a vastly greater pool of money for lending.

The scenario leaves questions unanswered, and certainly calls for continued improvement in the capital and credit environment for small business. One question to which we do not claim to have a complete answer is whether further deregulation will benefit small business.

On the one hand it is said that the commercial banks deregulated deposit base since it created a higher cost of funds for commercial banks has permanently raised the base on which small business loan rates are determined, and that it, therefore, penalizes this business segment which must borrow, and which has little surplus funds to invest.

There is some apparent logic to this argument, and it would seem that deregulation might penalize small business. On the other hand some experience points in a different direction.

Deregulation of consumer deposits and the limited deregulation of business deposits to date have caused banks to revise deposit account fee schedules in order to recover their increased cost of doing business.

Banks have also turned to other ways of cutting costs and expenses in order to counteract its new, greater cost of funds. High-technology, low-cost branches with fewer employees and greater mechanization through home banking systems are just a couple of examples of ways to streamline and reduce costs of delivery of services to small business and others.

In this scenario, one in which we believe loan rates and those who rely on credit, small-business owners, particularly, do not carry the full burden of our higher cost of funds structure. Then what does account for an 11-percent prime rate today? Certainly credit demand is the most likely answer and has been ably referred to earlier this morning. Demand created by a Federal deficit of $200 billion and a monetary policy which keeps interest rates high enough to prevent a new surge of inflation are two important factors.

Now in the absence of Chemical Bank's full control over those two subjects we have turned to what we're calling home remedies—to assist small business and to help assure ourselves frankly of a strong position in this vast and vital market segment. We're happy to report today that the competition in the small business market among big and small banks in the New York metropolitan area is hot, and that fact has truly got to be a plus for small business.

Just weeks ago Chemical Bank commissioned Research & Forecasts, an independent research firm, to conduct what we believe is a unique and valuable survey of the attitudes and opinions of small-business owners in our marketplace.

Our goal was to take a postrecession reading on the health of this important business segment, and we also wanted to look into the psychology and lifestyle of the small-business owner. The survey was conducted in July and August. Research & Forecasts spoke to over 1,000 randomly selected owners of companies with sales between $500,000 and $5 million per year.

Research & Forecasts places a 95-percent confidence level on the accuracy of these findings. The survey reports that the recovery has not yet fully reached small-business owners; 59 percent of our respondents said that they had not felt the impact of the economic upturn at all, or had felt it only slightly. This very substantial sector of our business community is still experiencing difficult economic conditions.

They see the principal limiting factors for growth as tight consumer spending, difficulty in finding qualified personnel, the high cost of energy, and the cost of financing. Over one-half said they worry most about inflation and interest rates much more, for example, than they worry about their ability to compete worldwide, and as recently as 2 months ago they predicted inflation and interest rates would be going up.

The 50 percent who anticipated higher interest and inflation rates in the future were expressing a serious note of pessimism on the recovery, we believe. The real impact clearly of this lack of confidence will come from delayed plans for expansion, additional hiring, and increased spending in general.

So what we've called our recession report card is certainly not all outstanding, but there are several very positive economic findings as well. "Small Business Speaks: the Chemical Bank Report" reveals that these entrepreneurs have learned from the recent recession, and seem to have turned adversity to their own advantage. Nearly half of our respondents say that their overall financial condition is stronger than it was at the peak of the recession. They are also better off in terms of demand for their product, and their ability to plan for the future.

Two out of three reported that as a result of their experience in the past recession, they will be better able to weather another. A final positive economic note, and one with national importance perhaps. Although our small-business owners in the New York metropolitan area reported over the past 2 years they had not increased their number of employees, a large percentage—a full 36 percent—now foresee creating jobs and new positions within the next 12 months. "Small Business Speaks" and covers many fascinating lifestyle questions as well, such as the full integration of the family into the small-business life.

It raises questions and certain paradoxes even about the family. Why, for instance, do so few small business owners recommend to their children that they follow in the parent's entrepreneurial path, recommending instead the professions or even big business.

I think you'll enjoy the personality as you review the report and the fullness of the report, but I'd like to continue to emphasize a few more business comments instead of the personal. Let me review briefly what small business owners say about the amount of regulation, the quality of public education, the banks and their assessment of what would reinvigorate the spirit of entrepreneurship in the United States.

When asked if they, today were experiencing less, the same or more Government regulation than 3 years ago, 81 percent said they experienced the same or more. Banking deregulation as an aside clearly has outpaced these other efforts. The quality of public education is receiving continuing national education and small business owners overwhelmingly report—it's 73 percent, in fact—that our public education system does not prepare one either for small business ownership or management.

Most of our respondents by the way had attended college. Our investigation of small business attitudes on trade associations, accountants, and banks gave high marks to two out of those three. Need I say more? Trade associations received a surprisingly high rating for importance as sources of information, business contacts and lobbying, and accountants were viewed practically as a member of the family.

The banks and the banking system were reported to have a way to go in meeting the needs of small businesses.

Sixty-five percent said that banks were more interested in big business than in small, and yet—and I think very interestingly 60 percent agreed—that the banks in our area generally met their credit needs.

In exploring their opinions on bank credit we discovered a great information gap, a gap between what is, in fact, available through banks, and what the small business community is aware of.

For example, although there was a fairly high level of awareness of SBA programs, there was little to no awareness of low rate programs such as industrial development bond financings or low rate second mortgage programs through New York State's job development authority as an example.

These findings suggest to us a need for an expanded informational role both on the part of the banks and government, particularly State and county level participation.

Many other areas of inquiry were pursued, and most were very revealing. One in particular has drawn a lot of comment since it speaks so clearly to what banks and Government should be doing, and I'd like to turn to Bill Mooney who will discuss that question and Chemical's programs for small business.

Mr. MOONEY. Thank you, Bill, and I thank you, Mr. Chairman and distinguished members of the committee. The question to which Bill alluded was, "Do you believe that the entrepreneurial spirit in America in recent years has declined, strengthened, or stayed the same?"

Unfortunately, 41 percent said it declined. We followed by asking the best ways to stimulate the entrepreneurial spirit. According to these independent achievers, easier access to financing, incentives such as tax credits, more business skills in public schools and easier access to equity. Chemical Bank cannot answer all these questions, but we're proud of our historical involvement with small business and also of a program which we initiated 1½ years ago, targeted directly at the small business owner's banking needs.

As the leading bank for small business in the metropolitan New York area, we realize that a special approach was called for, particularly when small business was suffering most during the recession.

We established the first team of small business experts, called a business action unit. This and subsequent teams had one charge: meet the needs of $500,000 to $5 million business community promptly, professionally, and knowledgeably.

I might also add one word, flexibly because as we focus more and more on the segment, we found that our knowledge and confidence grew, and we were better able to structure loans even when the economy was stalled.

We set the tone by making a massive outreach program of calling on small business, hosting educational seminars, providing grants to subsidize local community business programs and participating in low-rate loan programs.

The reaction was positive, and close to unanimous in the small business community, and we were making some money, too, I might add.

Over the past 6 months we've expanded a program from a pilot in one or two counties to cover the entire New York City area, an area of 240,000 businesses with sales under $5 million.

We emphasize credit because that's what the small business person needs, and we're an active lender under the SBA preferred lender's program. We also try to fill that information gap which Bill Wulfing referred to a few minutes ago.

As a sponsor of the New York Chamber of Commerce small business activities, we hosted five card exchanges where small business owners get together to do business. We sponsor down-to-earth seminars through the chamber like negotiating a commercial lease, and many more activities.

Small Business Week is a major event at Chemical Bank. Finding the best ways to respond to small business is not easy. We continue to look for sources of equity capital for small business, and we've had some success, but that is an area which we want to emphasize more in 1984.

Within months we will announce a new program for the first time in our area, which will make industrial revenue bond financing a truly viable alternative for the companies borrowing as little as $250,000 for real estate or capital improvements.

We're on the verge of publicly offering a low-cost sophisticated but not complicated cash management system which will be a pioneer of small business nationwide.

Chemical Bank recognizes the importance of small business to the economic well being of its immediate market area and of the country. We acknowledge its importance to our own corporation's future, and we are fully committed to being the small business leader among commercial banks through continued innovation and aggressive outreach to the small business community.

Thank you again for this opportunity to address the committee.

[Mr. Mooney's and Mr. Wulfing's joint prepared statement with attachments follows:]

JOINT PREPARED STATEMENT OF WILLIAM M. MOONEY, SENIOR VICE PRESIDENT, CHEMICAL BANK OF NEW YORK, AND WILLIAM H. WULFING, VICE PRESIDENT AND DIRECTOR OF SMALL BUSINESS, SMALL BUSINESS UNIT

I WOULD LIKE TO THANK CHAIRMAN NOWAK AND THE DISTINGUISHED MEMBERS OF THE COMMITTEE FOR OFFERING CHEMICAL BANK THIS OPPORTUNITY TO ADDRESS THE COMMITTEE ON SERIOUS ISSUES AFFECTING SMALL BUSINESS. AND I WOULD LIKE TO SPECIALLY THANK CHAIRMAN NOWAK FOR THE PERSONAL INTEREST HE HAS SHOWN IN SEVERAL CHEMICAL PROJECTS RELATING TO SMALL BUSINESS. MY COLLEAGUE, WILLIAM MOONEY, AND I WOULD LIKE TO BRIEFLY DISCUSS 3 SUBJECTS:

1) DEREGULATION AND SMALL BUSINESS LOAN RATES
2) THE RESULTS OF OUR RECENT SURVEY TITLED "SMALL BUSINESS SPEAKS: THE CHEMICAL BANK REPORT", AND
3) CHEMICAL BANK'S PROGRAM TO GUARANTEE THAT SMALL BUSINESSES' FINANCIAL NEEDS IN THE METROPOLITAN NEW YORK CITY AREA ARE MET.

WE REMEMBER WELL THE TIME SO RECENTLY WHEN THE MUTUTAL MONEY MARKET FUNDS HAD DRAINED BILLIONS FROM COMMERCIAL BANKS, AND SMALL BUSINESSES WERE FACED WITH THE DEBILITATING AND POTENTIALLY DESTRUCTIVE COMBINATION OF EXTREMELY HIGH INTEREST RATES AND INADEQUATE CREDIT AVAILABILITY. TODAY, WE—BOTH THE BANK AND ITS SMALL BUSINESS CUSTOMERS—ARE IN THE SIGNIFICANTLY MORE DESIRABLE POSITION OF BOTH A LOWER BORROWING RATE ENVIRONMENT AND, WITH THE RETURN OF MONEY MARKET DEPOSITS DUE TO DEREGULATION, THERE IS A GREATER POOL FOR LENDING. BUT THE SCENARIO LEAVES QUESTIONS UNANSWERED, AND CALLS FOR CONTINUED IMPROVEMENT IN THE CAPITAL AND CREDIT ENVIRONMENT FOR SMALL BUSINESSES.

ONE QUESTION--TO WHICH WE DO NOT CLAIM TO HAVE A COMPLETE ANSWER--IS WHETHER FURTHER DEREGULATION WILL BENEFIT SMALL BUSINESS. IT IS SAID THAT THE COMMERCIAL BANKS' DEREGULATED DEPOSIT BASE, SINCE IT REPRESENTS A HIGHER COST OF FUNDS TO COMMERCIAL BANKS, HAS PERMANENTLY RAISED THE BASE ON WHICH SMALL BUSINESS LOAN RATES ARE DETERMINED, AND THAT IT THEREFORE PENALIZES THIS SEGMENT WHICH MUST BORROW AND HAS LITTLE TO INVEST. THERE IS SOME APPARENT LOGIC TO THIS ARGUMENT AND IT WOULD SEEM THAT ADDITIONAL DEREGULATION MIGHT SERVE TO PENALIZE SMALL BUSINESS EVEN MORE. ON THE OTHER HAND, SOME EXPERIENCE POINTS IN A DIFFERENT DIRECTION.

DEREGULATION OF CONSUMER DEPOSITS AND THE LIMITED DEREGULATION OF BUSINESS DEPOSITS TO DATE HAVE CAUSED BANKS TO REVISE DEPOSIT ACCOUNT FEE SCHEDULES IN ORDER TO RECOVER INCREASED COSTS OF DOING BUISNESS. BANKS HAVE ALSO TURNED TO OTHER WAYS OF CUTTING COSTS AND EXPENSES IN ORDER TO COUNTERACT ITS NEW, GREATER COST OF FUNDS. HIGH TECHNOLOGY, LOW COST BRANCHES WITH FEWER EMPLOYEES AND GREATER MECHANIZATION THROUGH OUR PRONTO HOME-BANKING SYSTEM, ARE EXAMPLES. IN THIS SCENARIO, ONE IN WHICH WE BELIEVE, LOAN RATES--AND THOSE WHO RELY ON CREDIT, SMALL BUSINESS OWNERS--DO NOT CARRY

THE BURDEN OF OUR HIGHER COST OF FUNDS STRUCTURE.

THEN WHAT DOES ACCOUNT FOR AN 11% PRIME RATE TODAY? CREDIT DEMAND. DEMAND CREATED BY A FEDERAL DEFICIT OF $200 BILLION AND ALSO A MONETARY POLICY WHICH KEEPS INTEREST RATES HIGH ENOUGH TO PREVENT A NEW SURGE OF INFLATION.

IN THE ABSENCE OF FULL CONTROL OVER THESE SUBJECTS, CHEMICAL BANK HAS TURNED TO SOME PRACTICAL "HOME REMEDIES" TO ASSIST SMALL BUSINESS AND TO HELP ASSURE OURSELVES OF A STRONG POSITION IN THIS VAST AND VITAL MARKET SEGMENT. WE'RE HAPPY TO TELL YOU THAT THE COMPETITION IS HOT IN NEW YORK CITY, AND THAT HAS GOT TO BE A TREMENDOUS PLUS FOR SMALL BUSINESS!

JUST WEEKS AGO, CHEMICAL BANK COMMISSIONED RESEARCH AND FORECASTS, AN INDEPENDENT RESEARCH FIRM, TO CONDUCT WHAT WE BELIEVE IS A UNIQUE AND VALUABLE SURVEY OF THE ATTITUDES AND OPINIONS OF SMALL BUSINESS OWNERS IN OUR MARKET. OUR GOAL WAS TO TAKE A POST-RECESSION READING ON THE HEALTH OF THIS IMPORTANT BUSINESS SEGMENT, AND WE ALSO WISHED TO LOOK INTO THE PSYCHOLOGY AND THE LIFE-STYLE OF THE OWNERS OF SMALL BUSINESSES. THE SURVEY WAS CONDUCTED IN JULY AND AUGUST OF THIS YEAR:

> 1047 RANDOMLY SELECTED OWNERS OF COMPANIES WITH SALES BETWEEN $500,000 AND $5,000,000 PER YEAR WERE QUESTIONED. RESEARCH AND FORECAST PLACES A 95% CONFIDENCE LEVEL ON THE ACCURACY OF THESE FINDINGS.

THE SURVEY REPORTS THAT THE RECOVERY HAS NOT YET REACHED SMALL BUSINESS OWNERS. 59% OF THE RESPONDENTS SAID THAT THEY HAD NOT FELT THE IMPACT OF THE ECONOMIC UPTURN AT ALL OR HAD FELT IT ONLY SLIGHTLY.

THIS VERY SUBSTANTIAL SECTOR OF OUR BUSINESS COMMUNITY IS STILL EXPERIENCING DIFFICULT ECONOMIC CONDITIONS. THEY SEE THE PRINCIPAL FACTORS WHICH LIMIT THEIR GROWTH AS TIGHT CONSUMER SPENDING, DIFFICULTY IN FINDING QUALIFIED PERSONNEL, THE HIGH COST OF ENERGY AND THE COST OF FINANCING. (TABLE 1.13)

OVER HALF SAID THAT THEY "WORRY MOST" ABOUT INFLATION AND INTEREST RATES--MUCH MORE FOR EXAMPLE THAN THEY WORRY ABOUT THEIR ABILITY TO COMPETE WORLDWIDE. AND AS RECENTLY AS 2 MONTHS AGO THEY SAW INFLATION AND INTEREST RATES GOING UP.

THE FIFTY PERCENT WHO ANTICIPATED HIGHER INTEREST AND INFLATION RATES IN THE FUTURE WERE EXPRESSING A SERIOUS NOTE OF PESSIMISM ABOUT THE RECOVERY. THE REAL IMPACT OF THIS LACK OF CONFIDENCE, IN TERMS OF DELAYED PLANS FOR EXPANSION, ADDITIONAL HIRING AND INCREASED SPENDING IN GENERAL, MAY ACT TO SLOW THE NATIONAL RECOVERY UNTIL THE SMALL BUSINESS SECTOR BECOMES CONVINCED THAT ECONOMIC DIFFICULTIES ARE TRULY BEHIND US.

SO WHAT WE'VE CALLED OUR "RECESSION REPORT CARD" IS NOT ALL OUTSTANDING. BUT THERE ARE CLEARLY SEVERAL VERY POSITIVE ECONOMIC FINDINGS AS WELL. "SMALL BUSINESS SPEAKS" REVEALS THAT THESE ENTREPRENEURS HAVE LEARNED FROM RECENT RECESSION EXPERIENCES AND SEEM TO HAVE TURNED ADVERSITY TO THEIR ADVANTAGE.

NEARLY HALF OF OUR RESPONDENTS SAY THAT THEIR OVERALL FINANCIAL CONDITION IS STRONGER NOW THAN IT WAS AT THE PEAK OF THE RECESSION. (TABLE 1.5) THEY ARE ALSO "BETTER OFF" IN TERMS OF DEMAND FOR THEIR PRODUCT AND IN THEIR ABI-

LITY TO PLAN FOR THE FUTURE. TWO OUT OF THREE REPORTED THAT AS A RESULT OF THEIR EXPERIENCE OF THE PAST RECESSION, THEY WILL BE BETTER ABLE TO WEATHER ANOTHER.

AND A FINAL POSITIVE NOTE--ONE WITH NATIONAL IMPORTANCE, PERHAPS--ALTHOUGH OUR SMALL BUSINESS OWNERS REPORT THAT OVER THE PAST TWO YEARS THEY DID NOT INCREASE THEIR NUMBER OF EMPLOYEES, A LARGE PERCENTAGE--A FULL 36%--FORESEE CREATING NEW POSITIONS IN THE NEXT 12 MONTHS.

"SMALL BUSINESS SPEAKS" COVERS MANY FASCINATING LIFESTYLE QUESTIONS, SUCH AS THE INTEGRATION OF THE FAMILY INTO THE BUSINESS, WHILE STILL CAUSING ONE TO WONDER AT THE PARADOXES. WHY, FOR INSTANCE, DO SO FEW RECOMMEND TO THEIR CHILDREN THAT THEY FOLLOW THE PARENTS' ENTREPRENEURIAL PATH, RECOMMENDING INSTEAD THE PROFESSIONS, OR EVEN BIG BUSINESS?

YOU WILL ENJOY THE PERSONALITY AND THE FULLNESS OF THE REPORT, BUT TODAY I WILL CONTINUE TO EMPHASIZE THEIR BUSINESS COMMENTS. LET ME REVIEW BRIEFLY WHAT SMALL BUSINESS OWNERS SAY ABOUT THE AMOUNT OF REGULATION, THE QUALITY OF PUBLIC EDUCATION, THE BANKS AND THEIR ASSESSMENT OF WHAT WOULD REINVIGORATE THE SPIRIT OF ENTREPRENEURSHIP IN THE UNITED STATES.

WHEN ASKED "IS YOUR BUSINESS TODAY EXPERIENCING LESS, THE SAME, OR MORE GOVERNMENT REGULATION THAN IT DID BEFORE PRESIDENT REAGAN CAME INTO OFFICE?", 81% SAID THEY EXPERIENCE THE SAME OR MORE.

THE QUALITY OF PUBLIC EDUCATION IS RECEIVING CONTINUING NATIONAL ATTENTION. SMALL BUSINESS OWNERS OVERWHELMINGLY REPORT--73%, IN FACT--THAT OUR PUBLIC EDUCATION SYSTEM DOES NOT PREPARE ONE EITHER FOR BUSINESS OWNERSHIP OR MANAGEMENT. MOST OF THE RESPONDENTS, BY THE WAY, HAD ATTENDED COLLEGE.

IN OUR INVESTIGATION OF SMALL BUSINESS ATTITUDES ON TRADE ASSOCIATIONS, ACCOUNTANTS, AND BANKS--TWO OUT OF THREE GOT HIGH MARKS. NEED I SAY MORE? TRADE ASSOCIATIONS RECEIVED A SURPRISINGLY HIGH RATING FOR IMPORTANCE AS SOURCES OF INFORMATION, BUSINESS CONTACTS, AND LOBBYING. AND ACCOUNTANTS WERE VIEWED PRACTICALLY AS A MEMBER OF THE FAMILY. BUT THE BANKS AND THE BANKING SYSTEM WERE REPORTED TO HAVE A WAY TO GO IN MEETING THE NEEDS OF SMALL BUSINESS.

65% SAID THAT BANKS WERE MORE INTERESTED IN BIG BUSINESS THAN IN SMALL, AND YET, 60% AGREED THAT BANKS GENERALLY MET THEIR CREDIT NEEDS.

IN EXPLORING THEIR OPINIONS ON BANK CREDIT, WE DISCOVERED A GREAT "INFORMA-

TION GAP" BETWEEN WHAT IS IN FACT AVAILABLE AND WHAT THE SMALL BUSINESS COMMUNITY IS AWARE OF. FOR EXAMPLE, ALTHOUGH THERE WAS A FAIRLY HIGH LEVEL OF AWARENESS OF SBA PROGRAMS, THERE WAS LITTLE TO NO AWARENESS OF LOW RATE PROGRAMS SUCH AS INDUSTRIAL DEVELOPMENT BONDS, OR LOW RATE SECOND MORTGAGE FINANCING THROUGH NEW YORK'S JOB DEVELOPMENT AUTHORITY. THESE FINDINGS SUGGEST THE NEED FOR AN EXPANDED INFORMATIONAL ROLE, BOTH FOR THE BANKS AND FOR GOVERNMENT, PARTICULARLY AT THE STATE AND COUNTY LEVEL.

MANY OTHER AREAS OF INQUIRY WERE PURSUED AND MOST WERE VERY REVEALING. ONE IN PARTICULAR HAS DRAWN A LOT OF COMMENT SINCE IT SPEAKS SO CLEARLY TO WHAT BANKS SHOULD BE DOING, AND I WOULD LIKE TO TURN TO BILL MOONEY WHO WILL DISCUSS THAT QUESTION AND CHEMICAL'S PROGRAMS FOR SMALL BUSINESS.

MR. MOONEY'S COMMENTS

THANK YOU MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE.

THE QUESTION TO WHICH BILL ALLUDED WAS:

"DO YOU BELIEVE THE ENTREPRENEURIAL SPIRIT IN AMERICA IN RECENT YEARS HAS DECLINED, STRENGTHENED OR STAYED THE SAME?". UNFORTUNATELY, 41% SAID IT HAD DECLINED. WE FOLLOWED BY ASKING THE BEST WAYS TO STIMULATE THE ENTREPRENEURIAL SPIRIT ACCORDING TO THESE INDEPENDENT ACHIEVERS? EASIER FINANCING, INCENTIVES SUCH AS TAX CREDITS, MORE BUSINESS SKILLS TAUGHT IN PUBLIC SCHOOLS AND EASIER ACCESS TO EQUITY.

CHEMICAL BANK CANNOT ANSWER ALL THOSE ISSUES, BUT WE'RE PROUD OF OUR HISTORIC INVOLVEMENT WITH SMALL BUSINESS AND ALSO OF A PROGRAM WHICH WE INITIATED A YEAR AND A HALF AGO. TARGETED DIRECTLY AT THE SMALL BUSINESS OWNERS' BANKING NEEDS.

AS THE LEADING BANK FOR SMALL BUSINESS IN THE METROPOLITAN NEW YORK AREA, WE REALIZED THAT A SPECIAL APPROACH WAS CALLED FOR--PARTICULARLY WHEN SMALL BUSINESSES WERE SUFFERING MOST DURING THE RECESSION. WE ESTABLISHED THE FIRST TEAM OF SMALL BUSINESS EXPERTS, CALLED A BUSINESS ACTION UNIT. THIS AND SUBSEQUENT TEAMS HAD ONE CHARGE: MEET THE NEEDS OF THE $500,000 TO $5,000,000 BUSINESS COMMUNITY PROMPTLY, PROFESSIONALLY AND KNOWLEDGEABLY. I MIGHT ALSO ADD ONE WORD, "FLEXIBLY": BECAUSE AS WE FOCUSED MORE AND MORE ON THE SEGMENT, WE FOUND THAT OUR KNOWLEDGE AND CONFIDENCE GREW, AND WE WERE BETTER ABLE TO STRUCTURE LOANS, EVEN WHEN THE ECONOMY WAS STALLED. WE SET THE TONE BY MAKING A MASSIVE OUTREACH PROGRAM OF CALLING ON SMALL BUSINESSES, HOSTING EDUCATIONAL SEMINARS, PROVIDING GRANTS TO SUBSIDIZE LOCAL COMMUNITY BUSINESS PROGRAMS, AND BY PARTICIPATING IN LOW RATE LOAN PROGRAMS. THE REACTION WAS POSITIVE AND CLOSE TO UNANIMOUS IN THE SMALL BUSINESS COMMUNITY. AND WE WERE MAKING SOME MONEY TOO!

SO, OVER THE PAST 6 MONTHS WE'VE EXPANDED THE PROGRAM FROM A PILOT IN ONE OR TWO COUNTIES TO COVER THE ENTIRE NEW YORK CITY AREA, AN AREA OF 240,000 BUSINESSES WITH SALES UNDER $5,000,000. WE EMPHASIZE CREDIT BECAUSE THAT'S WHAT IS MOST NEEDED, BUT WE ALSO TRY TO FILL THAT "INFORMATION GAP" WHICH BILL WULFING REFERRED TO A FEW MINUTES AGO. AS THE SPONSOR OF THE NEW YORK CHAMBER OF COMMERCE'S SMALL BUSINESS ACTIVITIES, WE'VE HOSTED 5 CARD EXCHANGES WHERE SMALL BUSINESS OWNERS GET TOGETHER TO DO BUSINESS; WE SPONSOR DOWN-TO-EARTH SEMINARS THROUGH THE CHAMBER LIKE "NEGOTIATING A COMMERCIAL LEASE", AND MANY MORE ACTIVITIES. "SMALL BUSINESS WEEK" IS A MAJOR EVENT AT CHEMICAL BANK.

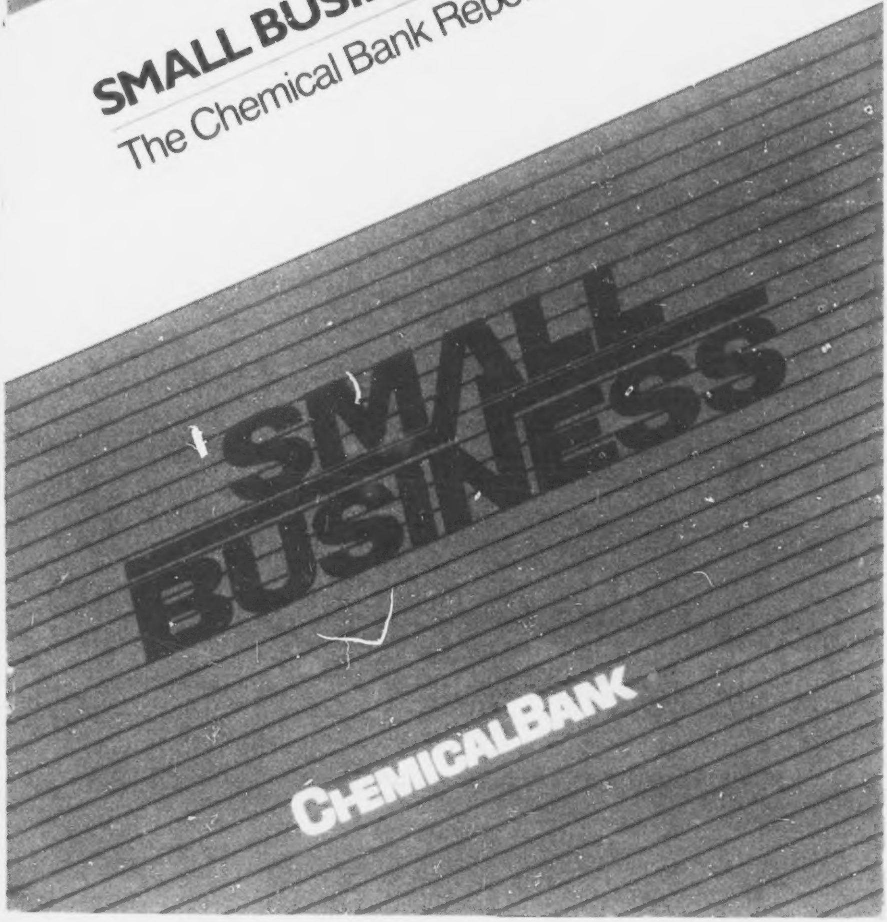
FINDING THE BEST WAYS TO RESPOND TO SMALL BUSINESS NEEDS IS NOT EASY. WE CONTINUE TO LOOK FOR SOURCES OF EQUITY CAPITAL FOR SMALL BUSINESS, AND WE'VE HAD SOME SUCCESS, BUT THAT IS AN AREA WE WANT TO EMPHASIZE MORE IN 1984. WITHIN MONTHS WE WILL ANNOUNCE A PROGRAM WHICH FOR THE FIRST TIME IN OUR AREA WILL MAKE INDUSTRIAL REVENUE BOND FINANCINGS A TRULY VIABLE ALTERNATIVE FOR COMPANIES BORROWING AS LITTLE AS $250,000 FOR REAL ESTATE OR CAPITAL IMPROVEMENTS. AND WE'RE ON THE VERGE OF PUBLICLY OFFERING A LOW COST SOPHISTICATED, BUT NOT COMPLICATED, CASH MANAGEMENT SYSTEM WHICH WILL BE A PIONEER FOR SMALL BUSINESSES NATIONWIDE!

CHEMICAL BANK RECOGNIZES THE IMPORTANCE OF SMALL BUSINESS TO THE ECONOMIC WELL-BEING OF ITS IMMEDIATE MARKET AREA AND OF THE COUNTRY. WE ACKNOWLEDGE ITS IMPORTANCE TO OUR OWN CORPORATION'S FUTURE,AND WE ARE FULLY COMMITTED TO BEING THE SMALL BUSINESS LEADER AMONG COMMERCIAL BANKS THROUGH CONTINUED INNOVATION AND AGGRESSIVE OUTREACH TO THE SMALL BUSINESS COMMUNITY.

THANK YOU AGAIN FOR THIS OPPORTUNITY TO ADDRESS THE COMMITTEE.

SMALL BUSINESS SPEAKS

The Chemical Bank Report


SMALL
BUSINESS
CHEMICALBANK

SMALL
BUSINESS
SPEAKS

SMALL BUSINESS SPEAKS:
The Chemical Bank Report

Conducted for Chemical Bank
By
RESEARCH & FORECASTS, INC.

COPYRIGHT CHEMICAL BANK, 1983
PERMISSION IS HEREBY GRANTED TO REPRINT ALL OR A
PORTION OF THIS MATERIAL PROVIDED A CREDIT LINE
IS INCLUDED FOR:
SMALL BUSINESS SPEAKS: THE CHEMICAL BANK REPORT
52 BROADWAY, NEW YORK, NEW YORK 10004

SMALL BUSINESS SPEAKS

Preface

Small business owners are a unique breed. Every day challenges their livelihood, while presenting opportunities to reach for even greater heights. The road to success is laden with sacrifice—in physical and emotional stress, in lack of family and leisure time, in financial risk. Yet, if given a choice, the vast majority would refuse to alter their course in pursuit of independence, self-fulfillment and financial security.

Over the past two decades, the entrepreneurial spirit in America has been tested, twisted, bent and for many people, broken. Taxes, regulation, the high cost of energy and commercial space, shortages of skilled labor and lack of financing, not to mention economic recessions, have laid waste to the most carefully planned business ventures, and led to more bankruptcies in the past two years than at any time since the Great Depression. Clearly many of the small business owners view themselves as survivors. Their "me against the world" attitude drives them to success.

Small Business Speaks achieves our goal of providing entrepreneurs, as a group, with a forum for airing their concerns on the current and future state of small business and for sharing their reflections on the ways in which running a small business affects their personal lives. It paints a unique picture of the personal and professional aspirations of today's successful entrepreneur.

Chemical Bank recognizes small business as a dynamic market segment in the 1980's. Much more needs to be done if small businesses are to thrive in the years to come. *Small Business Speaks* sets out clear mandates for banks as well as other private and public institutions. We see the challenge before us and are committed to meeting it.

Robert I Lipp

Robert I. Lipp
President-Elect

New York, September 21, 1983

SMALL
BUSINESS
SPEAKS

Methodological Note

The definition of "small business" for the purposes of this survey covers Dun & Bradstreet-listed companies with annual sales figures between $500,000 and $5 million.

One thousand and forty-seven (1047) interviews were conducted between July 5, 1983 and August 15, 1983 with small business people. Seventy-nine (79) interviews were conducted with accountants who serve small business between August 4, 1983 and August 12, 1983.

"Owners" is used in this study as a term of convenience covering owners, partners, principal stockholders, presidents, or chief executives. The majority of the respondents have a proprietary interest in the companies.

"The New York metropolitan area" in this study refers to the following nine New York state counties: five are referred to as "urban counties," New York, The Bronx, Queens, Kings, and Richmond; and four as the "suburban counties," Westchester, Rockland, Nassau, and Suffolk.

Data on the small businesses were weighted to reflect the actual distribution of small businesses throughout the nine counties. See the Methodology at the end of this report for a full discussion of the study design.

SMALL
BUSINESS
SPEAKS

Table of Contents

Overview 7

Chapter I **Optimism in the Face of Economic Adversity** 13
- Introduction 14
- A Recession Report Card 14
- The Troubled Economy 17
- Factors Limiting Growth 21
- Small Business's Optimism 23

Chapter II **Balancing the Demands of Personal and Professional Life** 27
- Introduction 28
- Many Days and Long Hours 28
- Stress and its Effects 30
- The Family Provides Relief 31
- Is It Worth It? Yes 36
- But for Your Children? 38

Chapter III **The Business Neighborhood** 41
- Introduction 42
- What Needs Attention 42
- Low Marks for Public Education 46
- Dissatisfaction with County Government 47
- Inactivity in Community Affairs 48
- Staying in the New York Area 49

Chapter IV **Banks and Trade Associations: How Helpful Are They?** 53
- Introduction 54
- A Challenge to Banks 54
- Finding Money to Grow 56
- Trade Associations: Old and New Roles 59

Chapter V **Counting on the Accountant** 61
- Introduction 62
- The Crucial Role 62
- Accountants and Small Business 64
- Accountants on National Issues Affecting Small Business 65
- Accountants on Local Issues Affecting Small Business 70

Appendix I **New York Metropolitan Area Small Business Owners: A Profile** 73

Appendix II **Methodology** 81

SMALL
BUSINESS
SPEAKS

Overview

Small Business Speaks: The Chemical Bank Report is the first comprehensive effort to document the professional and personal concerns of small business owners in the New York metropolitan area. Serious studies have investigated the issues that interest mid-sized companies or large corporations, and a wealth of anecdotal material is available on smaller neighborhood stores (below $500,000 in sales). But *The Chemical Bank Report* is the first systematic effort to map the economic and business expectations, as well as lifestyle patterns, of business owners in the uncharted realm between the smallest and the mid-size endeavors: small businesses with sales between $500,000 and $5 million.

Small Business Speaks arrives at some surprising and perplexing conclusions about the metropolitan area's small business owners, among them:

- Despite optimism for their firm's future, only a minority of respondents expect small business to play an increasing role in the American economy.
- Despite confidence in their own ability to learn from the recession and succeed, only a minority believe small business can make a significant contribution to the country's economic growth.
- Despite personal financial success, respondents record noteworthy levels of stress and its companions, irritability and medical problems.
- Juxtaposed with assertions that starting or owning one's own business is well worth all the sacrifices, and the fact that almost all those surveyed would do it again, few respondents wish their own children to enter their own businesses.
- Despite the availability of government, banking and educational programs designed to help entrepreneurs, strikingly few respondents believe government at any level, banks, or public education systems have helped small business owners very much at all.

Small business owners appear to have found comfortable answers to these puzzles and paradoxes primarily because they have developed an extraordinary capacity to focus on critical essentials: business and family. They devote vast numbers of hours to each, often combining the two. Although they are concerned about the national economic outlook, and although they believe governments, banks and the educational system have failed to offer substantive support, small business owners are nonetheless overwhelmingly self-confident about the lessons their own firms have learned from the recession, resilient and optimistic about personal chances for success. What emerges so clearly from this survey of the way small business owners balance business and personal concerns is that they see themselves essentially as model rugged individuals, buffeted by chance and circumstance, but successful upstream swimmers.

This vibrant self-confidence emerges in every section of the investigation and is immediately clarified by posing a sequence of commonsense questions:

- How do small business entrepreneurs view their role in local, metropolitan, and national economies?
- How do small business owners balance the complex task of fulfilling responsibilities to both occupation and family?
- What neighborhood and municipal support problems do small entrepreneurs identify and how do they respond?
- How do small business executives evaluate the private sector support system of banks and trade associations?
- What are their future goals for their businesses and their offspring?

The answers to these questions illuminate the resolution and commanding determination of seldom-noticed owners of small business in the face of adversity. This personal, straightforward, no-nonsense approach to business and personal life contrasts sharply with their view of business prospects nationally and is illustrated well in responses to two questions. When asked whether the entrepreneurial spirit in America had declined in recent years, a plurality of 41% replied that it had indeed declined, while 29% said it had stayed the same, and only one-quarter believed that spirit had been strengthened. When asked what might stimulate the entrepreneurial spirit best, pluralities of 38% and 31% chose immediate measures, such as easier financing for new businesses, and incentives, such as tax credits, over teaching more business skills in the public schools.

SMALL
BUSINESS
SPEAKS

Table A **Has the Entrepreneurial Spirit Declined?**
Do you believe the entrepreneurial spirit in America in recent years has:

	%
Been strengthened	26
Declined	41
Stayed the same	29
Don't know/No answer	4
(Number of respondents)	(1047)

Table B **Stimulating the Entrepreneurial Spirit**
Which of the following would be the *one or two best ways* to stimulate the entrepreneurial spirit?

	%
Easier financing for new businesses	38
Incentives, such as tax credits	31
More business skills taught in the public schools	25
Easier access to equity capital in public and private markets	24
Reduce government regulation	19
Changes in society's attitudes toward business people	14
(Number of respondents)	(1047)

Optimism In The Face of Economic Adversity

Though the economy, on a national level, is in the midst of a strong recovery, the recession is not over yet for a substantial number of small businesses in the New York metropolitan area. A 59% majority of executives report feeling a "slight impact" or "no impact at all" when asked about the recovery. Only 22% say they have "definitely" felt the recovery's impact. Similarly, nearly two in three (64%) executives give negative marks to the present economic climate as it affects small business.

Respondents are further convinced that inflation rates and interest rates (of more concern to small entrepreneurs than taxes) will rise in the near future. In addition, many small business owners believe they can't get a fair hearing from local governments, nor that government is fostering a good business climate. Although extremely optimistic about their own business chances, respondents are divided about prospects for small business generally.

Balancing the Demands of Personal and Professonal Life

Owning a small business can be an exacting responsibility, and perhaps one of the reasons respondents are generally optimistic about their own firm's chances is that they are willing to put in long hours and many days per week into occupational tasks. Three out of four (75%) work nine hours or more each day, and more than a third (36%) work eleven or more hours each day. One in three owners also devote more than five days a week to their businesses. This level of personal industriousness raises a classic dilemma for all small business owners: how to balance competing responsibilities to occupation and family?

The personal cost of hard work is clearly high, since about four out of ten (37%) of the sample report a great deal of work-related stress, and another four out of ten (43%) at least a "moderate" amount of stress. The same percentage, 43%, also believe that work-related stress is personally detrimental, while only three out of ten (32%) suggest it has no effect. For those who consider stress detrimental, a large majority (72%) claim it causes them to be irritable, and four out of ten say stress causes health problems and difficulty sleeping.

Surrounded by demands on time and work stress, small entrepreneurs nevertheless make substantial efforts to preserve close family relations. Eighty-five percent (85%) of the respondents are married, and in response to the demands of work, protect time with family by reducing their leisure and vacation activities. But entrepreneurs reveal another effort to protect family ties that is found less often among professionals in other occupations: they employ family and relatives in the firm. More than one-quarter (27%) report a spouse working in the business, over one-third report children in the business, and almost four in ten (38%) say other relatives in the business. In short, respondents not only protect family time; they also integrate family into the work context. It is not surprising that, more than any other source of relief, entrepreneurs cite time with family (64%) and friends (59%), as well as engaging in physical activity (60%), as the ways they most often manage work stress.

The Business Neighborhood

Although small business owners display a low level of satisfaction with the way public institutions have performed their duties, they nevertheless do not make substantial commitments of time and resources for improving their business neighborhoods.

Small businessmen are concerned about a variety of local issues, but their chief concern is crime (55%), followed by worries about viable commerical space. About one-third of the respondents cite each of the following: cost of commercial space, neighborhood cleanliness, traffic congestion and parking, deteriorating neighborhoods, and lack of local government support. Businessmen are not only worried about these problems. They also do not believe government officials are responsive to such concerns.

Respondents do not generally believe they can get a fair hearing from government officials on any level, nor do they believe their counties are doing a good job of fostering a healthy climate for small businesses. Perhaps this pattern of disillusion with government performance, along with substantial work commitments, help explain low levels of civic involvement among entrepreneurs.

Among the institutions that disappoint respondents, the public education system deserves special attention. Almost three-quarters of the respondents (73%) believe the education system does *not* provide skills and training for business ownership or management. Further, the majority (55%) of entrepreneurs believe on-the-job training or work experience is the *best* preparation for business ownership, compared to a much smaller vote (22%) for college education, and (12%) for a masters degree in business administration. In general, only one-quarter of the sample believe that the best way to stimulate the entrepreneurial spirit in America would be for public schools to teach more business skills. A clear plurality of four out of ten, by contrast, believe the best entrepreneurial stimulus would be to provide easier financing for new businesses, and an additional 24% recommend easier access to equity capital in public and private markets.

Disillusion with public services and official access does not lead to widespread thinking about relocation; most entrepreneurs plan to stay in their own areas. Only 18% of the sample say they are likely to relocate within the next two years. Rather, disappointment with civic resources appears to reinforce the intense individualism already evident in the New York area's successful entrepreneurs. Rather than expect much from public institutions, they want easier access to financing for those ambitious individuals who, like themselves, are willing to labor hard and long enough to make a business prosper.

Banks and Trade Associations: How Helpful Are They?

Consistent with their prevailing "lone eagle" orientation, receiving little assistance from others, small businessmen believe they receive little attention from banks. About two-thirds of the respondents (65%) believe banks are more interested in big business than in small business. Although half (52%) say a banker has visited them personally within the last year, only 37% rate banks as good or excellent in providing financial services to small businesses, and 52% believe banks have done only a fair to poor job. Trade associations are considered more helpful, with six out of ten (60%) rating them very or somewhat important, especially regarding: general business information, marketing information, lobbying efforts, and as sources of business contacts.

Curiously, alongside their criticism of access to banking services, small businessmen appear strikingly ill-informed about services that banks, and banks together with local governments, provide. Respondents reveal they are not at all well informed about municipal or county low-rate industrial development bonds, or other programs for low-rate capital financing. This information "gap" between what is available and what entrepreneurs know suggests that banks can play a critical role for small businesses if they make initial efforts simply to keep them informed about low-cost financing opportunities.

Faced with what they consider a lack of general support from the outside, small businessmen rely chiefly on accountants for handling a wide array of business problems, and given their importance, it is also striking to learn that the most frequently cited complaint about banks is the lack of coordination between banks and accountants.

The Future

Consistent with their views on other issues, for entrepreneurs the future is as compartmentalized and tightly focused as their own career histories. Trusting themselves, family, close friends, and accountants, small businessmen demonstrate a remarkable ability to distance themselves from their surroundings.

Despite their pessimism about rising interest and inflation rates, respondents are clearly happy they chose to create their own businesses, and despite lack of regular hours or leisure opportunities, the vast majority of respondents would do it again. Yet, few, only 34%, have made any preparation for the transfer of management or ownership despite median ages in the middle-aged category. Further, what parents expect for themselves and what they wish for the future of the firm and their children are quite different matters. Only 18% wish their children to enter their own businesses, while 30% recommend entering a "profession," and another 22% wish them to start their own business or work for another company.

Many respondents believe their efforts are not directed toward building an enduring enterprise that grows beyond their own lifetime. Their vision of the American dream is not that their children enter their own businesses, but that children enter professions or even other businesses, preferably large ones, unlike their own. Small business owners in the New York metropolitan area view themselves and their businesses as transitional steps in a struggle toward a better life. They are classic Americans, fulfilling the goals of independent achievement through personal struggle. Their enterprises are viewed as useful for one generation of family entrepreneurs, not an inheritance but a resource for individual and family aspirations.

SMALL
BUSINESS
SPEAKS

Chapter I

Optimism in the Face of Economic Adversity

SMALL BUSINESS SPEAKS

Introduction

The recession is not over yet for the small business person. Only four in ten small business owners in the New York metropolitan area have felt the impact of the national economic upturn. Only one in five say they have increased the number of employees. But if they are still down, they do not feel beaten. Seven in ten say that their recent experiences have left them better able to weather another recession.

The national economy is an ever-present concern. The economy in general, according to these entrepreneurs, will be the number one issue in the next presidential election. They are especially concerned about interest and inflation rates, both of which the small business people expect to go up. And only one in seven say they feel less government regulation than before President Reagan came into office. The small business owners foresee tight consumer spending, finding qualified personnel, and cost of energy as factors very likely to limit their growth in upcoming years.

Yet despite their current situation and concerns about the economy, the entrepreneurs are overwhelmingly optimistic about their own ability to succeed in the 1980s. Nearly four in ten foresee creating new positions in their companies during the next year.

A Recession Report Card

The recession is clearly not yet over for the small businesses in the New York metropolitan area. Less than one in four (22%) of the business owners say they have definitely felt the impact of the economic upturn, but a majority (59%) say they have only slightly felt the upturn (23%) or have not felt it at all (36%).

Small business executives in the suburban counties are somewhat more likely than their urban counterparts to say they have felt the economic upturn. Forty-three percent (43%) say they have definitely or somewhat felt the economic upturn, compared with 37% in urban counties. The small business people in Queens (30%) are the least likely to say they have definitely or somewhat felt the economic upturn, while the business people of Rockland and Staten Island are most likely, at 48% and 47% respectively, to say they have felt the upturn.

> **Observation**
> The economy as a whole, according to many national economic indicators, is moving strongly out of the recession. Though analysts vary on their outlook for the future, the view that the recession is behind us is broadly shared by many economists and business leaders, and is widely reported by the media. It is a view, however, that is not shared by many New York metropolitan area small business owners. A sizable majority still feel they are operating in a recessionary economic climate.

These findings serve as an important reminder—to government agencies, businesses and professionals servicing the small business sector, and the media—the gross economic indicators only tell part of the story. Public and private institutions must not overlook the difficult economic conditions still being felt by a substantial sector of the business community.

Table 1.1 **Have You Felt the Economic Upturn by County***
Has your business felt yet the impact of the economic upturn?

	All Respondents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Westchester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Definitely	22	21	21	18	22	25	23	24	30	22
Somewhat	17	17	19	12	14	22	18	24	16	19
Only slightly	23	22	29	24	35	16	27	19	19	21
Not at all	36	40	31	41	29	35	31	28	30	34
Don't know/ No answer	2	0	0	4	0	2	1	5	5	3
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Table 1.2 **Have You Felt the Economic Upturn by County Type**

	All Respondents	Urban	Suburban
	%	%	%
Definitely	22	21 }37%	25 }43%
Somewhat	17	16	18
Only slightly	23	24	22
Not at all	36	38	32
Don't know/No answer	2	1	4
(Number of respondents)	(1047)	(736)	(311)

Despite the uncertainty of the economic upswing, a small majority of the small business owners (60%) say they are today employing the same number of people as during the peak of the most recent recession. One in five (21%) say they employ more people and 17% say they employ less.

Table 1.3 **Change in Number of Employees Since the Recession**
Is this more, less or the same number of employees since the midst of the most recent recession?

	%
More	21
Less	17
The same	60
Don't know/No answer	2
(Number of respondents)	(1047)

*Percentages may not add up to 100% because of rounding off or multiple responses.

Nearly seven in ten (67%) small business leaders in the New York metropolitan area say they have come out of the most recent recession better able to confront any future economic hard times. Only one in five (20%) say they are not better prepared for another recession.

Nearly half (46%) say that they are today in an improved position in terms of their overall financial strength since the trough of the recession, and four in ten say that they are also better off in their ability to plan for the future (39%), in terms of profits (38%), and in terms of offering better products and services (36%). Small business owners are least likely to report that their experience of the past recession has made their company better off in terms of the level of competition (27% saying that the recession has left them worse off).

Two out of every three small business owners in the New York area say they will be better able to handle another recession because of their recent experience, and sizable numbers feel they are better off in terms of overall financial strength, the products or services they offer, ability to plan for the future, and management strength. Still, in spite of these improvements, one in four say they are worse off in terms of profits than they were during the peak of the recession. While the recession may have had some benefits, its pain is still being felt.

Table 1.4 **Ability to Weather Another Recession by Industry Type***
Do you think that as a result of your experience of the past recession, you would be better able to weather another recession?

	All Respondents	Manufacturing	Wholesale	Retail	Services	Construction	Communications	Finance
	%	%	%	%	%	%	%	%
Yes	67	66	67	69	72	66	72	67
No	20	22	20	19	12	16	22	19
Don't know/ No answer	12	12	13	12	16	17	6	14
(Number of respondents)	(1047)	(439)	(250)	(167)	(56)	(52)	(34)	(15)

* All tables showing industry type are categorized by standard SIC codes labeled as follows: manufacturing; wholesale; retail; services other than financial; construction; communications, including transportation, communications, and other public utilities; and finance, including finance, insurance, and real estate.

Table 1.5

Strength of Company after Recession
Is your company today generally better off, worse off, or the same as it was at the peak of the recession in:

	Better Off	Worse Off	The Same	Don't Know/ No Answer
	%	%	%	%
Overall financial strength	46	16	35	3
Demand for your products or services	43	18	36	2
Your ability to plan for the future	39	12	43	6
Profit	38	26	34	3
Better products or services	36	9	50	5
The use of new technology	34	3	48	14
Management strength	32	5	60	3
The level of productivity	31	17	49	3
The amount of competition	20	27	50	2
(Number of respondents)	(1047)			

Observation
Economists claim that a recession, though not without painful social costs, can have a positive effect on the economy by forcing out weaker companies and fostering stronger performance and increased efficiency among those that survive. This view is certainly borne out by the attitudes of the small business owners in this survey.

The Troubled Economy

What entrepreneurs believe about their own prospects may not mirror their expectations for the economy as a whole. When asked how they would rate the present economic climate as it affects businesses the size of their own, almost two-thirds of New york metropolitan area entrepreneurs (64%) rate it negatively. Of those who give it a negative rating, 47% rate the economy fair and 17% rate it poor. About one-third (33%) give the economy a positive rating of which only 5% say it is excellent and 28% say it is good.

Table 1.6

Current Economic Climate
How would you rate the present economic climate as it affects businesses the size of your own?

	%	
Excellent	5	33%
Good	28	
Fair	47	64%
Poor	17	
Don't know/No answer	2	
(Number of respondents)	(1047)	

On the national level, small business owners are concerned most about inflation and interest rates. When asked what national economic factors they worry about the most, about half say inflation (55%) and interest rates (51%) are pressing concerns. The third most common concern is taxes, mentioned by 35% of the business executives. Only about one in four select unemployment (27%), the federal deficit (21%), and the ability of American business to compete worldwide (25%).

Table 1.7 **National Economic Factors of Most Concern**
What national economic factors do you worry about the most?

	%
Inflation	55
Interest rates	51
Taxes	35
Unemployment	27
Ability of American business to compete worldwide	25
The federal deficit	21
Regulation	12
(Number of respondents)	(1047)

Leaders of small businesses were asked a series of questions concerning their views about how certain economic indicators will move over the next twelve months. Half (52%) believe interest rates will rise during the next year. Only one out of ten (10%) believe interest rates will go down, and one out of three (32%) believe interest rates will hold steady.

Table 1.8

Interest Rates: Up or Down?
Do you think interest rates over the next twelve months will:

	%
Go up	52
Hold steady	32
Go down	10
Don't know/No answer	6
(Number of respondents)	(1047)

Observation

These attitudes—continued concern about high rates and an expectation of higher rates in the future—underscore the central finding that many in the small business community have not yet seen an end to the recession. A sizeable percentage of executives have not experienced an increase in demand for products or services. Many associate a recessionary economy with high rates, as occurred in the last recession, and the 50% who foresee high rates in the future are expressing a note of pessimism on the recovery. The real impact of this lack of confidence—in terms of delayed plans for expansion, additional hiring and increased spending in general—may act to slow the national recovery until the small business sector becomes convinced that economic difficulties are truly behind us.

About half of the New York area entrepreneurs (50%) believe inflation will go up over the next twelve months. Only 7% believe it will go down, but a significant number (40%) believe it will hold steady.

Table 1.9

Inflation: Up or Down?
Do you think inflation over the next twelve months will:

	%
Go up	50
Hold steady	40
Go down	7
Don't know/No answer	3
(Number of respondents)	(1047)

Most small business owners do not believe there has been any significant change in the amount of government regulation their business experiences since President Reagan came into office. Two-thirds (66%) claim their business experiences the same amount of regulation and about an equal number say they experience more regulation.

Table 1.10 **Government Regulation**

Is your business today experiencing less, the same, or more government regulation than it did before President Reagan came into office?

	%
More regulation	15
Less regulation	14
The same amount	66
Don't know/No answer	5
(Number of respondents)	(1047)

The issue which small business owners most commonly say will affect their choice in the next presidential election is the economy. Almost one out of five (18%) single out the economy as a key issue.

Fourteen percent (14%) specify inflation as a possible key issue which may affect their choice, and 11% mention foreign policy. Two other key factors mentioned by nearly one out of ten entrepreneurs are unemployment and taxes.

Table 1.11 **Presidential Election Issues**

What are *one or two* key issues that would affect your choice in the next presidential election?

	%
Economy	18
Inflation	14
Foreign policy	11
Taxes	9
Unemployment	9
Interest rates	6
Balanced budget	5
Government spending	4
Less government regulation	3
World peace	3
World competition	1
(Number of respondents)	(1047)

SMALL BUSINESS SPEAKS

Factors Limiting Growth

According to small business owners, the most serious factors which may potentially limit the growth of their businesses are tight consumer spending, the cost of energy, and the difficulty in finding qualified personnel. About two of every three entrepreneurs in the metropolitan region say that tight consumer spending (65%), the cost of energy (62%), and finding qualified personnel (63%) are very or somewhat likely to curtail growth.

Table 1.12 **What May Limit the Growth of Your Business**

Here is a list of factors which can limit the growth of some businesses. For each one tell me whether it is very likely, somewhat likely, or not at all likely to limit the growth of *your* business.

	Very Likely		Somewhat Likely	Not at All	Don't Know/ No Answer
	%		%	%	%
Tight consumer spending	35	|-65%-|	30	32	3
Finding qualified personnel	33	|-63%-|	30	34	1
Cost of energy	33	|-62%-|	29	35	1
Local taxes	29		36	33	2
Federal and state corporate income tax	28		34	35	3
Cost of financing	27		28	42	3
Cost of insurance	25		34	40	1
Personnel costs	24		35	38	3
Increased competition from businesses the size of yours	23		40	36	1
Availability of financing	22		29	47	3
Government regulation	20		27	50	2
Competition from large businesses	19		33	48	1
Foreign competition	17		13	67	3
Technological change	14		28	56	3
Competition from street vendors or local flea markets	4		6	86	3
Other	7		1	9	83
(Number of respondents)	(1047)				

When asked to identify the single factor the business people consider potentially very limiting to their business's growth, about one in ten entrepreneurs (12%) mention tight consumer spending and the difficulty in finding qualified personnel (10%). These two issues emerge as the most pressing concerns of small business owners regarding their company's growth.

Table 1.13 **Most Limiting Factor**

You mentioned several factors as potentially very limiting to your business's growth. Which single factor do you expect to have the most serious impact?

	%
Tight consumer spending	12
Finding qualified personnel	10
Foreign competition	8
Cost of financing	7
Increased competition from businesses the size of yours	5
Government regulation	5
Federal and state corporate income tax	5
Availability of financing	4
Personnel cost	3
Technological change	3
Cost of insurance	1
Street vendors	1
Other	24
(Number of respondents)	(1047)

Small Business's Optimism

Despite awareness of factors limiting growth, the typical small business person in the New York metropolitan area is, on the whole, surprisingly optimistic. Nine in ten (89%) say they are optimistic about their business's ability to succeed in the 1980s — over half (55%) say they are very optimistic and another 34% say they are somewhat optimistic. Only one in ten say they are somewhat (8%) or very (1%) pessimistic about success for their company in the coming decade.

A few industry sectors are more optimistic about their future: finance (including insurance and real estate companies) and service firms. Communications companies appear to be somewhat more pessimistic than the average.

Table 1.14 **Facing the 1980s by Industry Type**
Are you optimistic or pessimistic about your business's ability to succeed in the 1980s?

	All Respondents	Manufacturing	Wholesale	Retail	Services	Construction	Communications	Finance
	%	%	%	%	%	%	%	%
Very optimistic	55	53	54	57	64	55	47	73
Somewhat optimistic	34	36	34	33	32	34	16	20
Somewhat pessimistic	8	8	8	8	1	8	28	7
Very pessimistic	1	1	1	2	0	1	4	0
Don't know/No answer	2	2	3	1	2	1	5	0
(Number of respondents)	(1047)	(439)	(250)	(167)	(56)	(52)	(34)	(15)

SMALL BUSINESS SPEAKS

A majority of small business executives in the metropolitan areas (59%) do not foresee creating new positions within their company in the next twelve months. A significant number (36%), however, do foresee creating new positions.

Larger firms, those with annual sales of $3 to $5 million, are somewhat more likely to say they foresee creating new positions during the next year. About four in ten (43%) of owners from those firms say they expect to create new positions. Somewhat less (37%) of the businesses in the $1 to $2.9 million category expect to create new positions, and only one-third (31%) of those in the $500,000 to $1 million category expect to create new positions.

Table 1.15 **New Hiring by County**
Do you foresee creating new positions in the next twelve months?

	All Respon-dents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	West-chester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Yes	36	31	48	35	39	42	42	57	41	33
No	59	65	44	54	53	58	52	38	56	61
Don't know/ No answer	6	5	8	11	8	0	6	5	3	6
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Table 1.16 **New Hiring by Size of Firm**
Do you foresee creating new positions in the next twelve months?

	All Respon-dents	Under $1 Million	$1 to $2.9 Million	$3 to $5 Million
	%	%	%	%
Yes	36	31	37	43
No	59	64	57	52
Don't know/No answer	6	5	6	6
(Number of respondents)	(1047)	(385)	(481)	(166)

Although they are quite optimistic about their own company's future success, entrepreneurs are divided as to whether small businesses have as much potential today as in the past to contribute significantly to the country's future economic growth. As many (36%) say that small businesses today have more potential as say they have less potential. Another 24% say their potential today is the same as in the past.

Table 1.17 **The Potential of Small Business**
Do you feel small businesses have as much potential today as in the past to contribute significantly to the country's future economic growth?

	%
More potential today	36
Less potential today	38
The same potential	24
Don't know/No answer	2
(Number of respondents)	(1047)

Observation
It is almost a cliche to talk of small business owners in terms of "independence" and "rugged individualism." Yet in reading these findings, one cannot help but admire the tenacity and competitiveness with which small business owners face the world. They have been battered by the recession and do not see much relief ahead. All by themselves they fight through problems handled by scores of executives at larger corporations. They spend long hours away from family and friends, and as seen in the following chapter, they endure considerable job-related stress.

These difficulties have, quite understandably, begun to shake their optimism. Many feel that the "entrepreneurial spirit" has declined in recent years and a sizable minority believe that small business has less potential today to contribute significantly to the nation's economic growth.

But in spite of all this, the great majority of small business owners remain steadfastly optimistic about their own future and their company's ability to succeed. Not only do they give no indication of giving up, but an overwhelming majority (91%) say they would choose to go into their own business again if they had to do it all over.

It may be a cliche, but it cannot be denied: small business owners are a strikingly independent, ruggedly individualistic lot.

SMALL
BUSINESS
SPEAKS

Chapter II

Balancing the Demands of Personal and Professional Life

Introduction The small business owner is a family person and despite all the work-related stresses suffered, has remained positive about both work and family. The executive finds relief from work stress in family activities and often integrates family with business by having a spouse or children in the firm.

Many Days and Long Hours

The typical entrepreneur devotes long hours to his company. Three out of four (76%) work nine hours or longer a day. Forty percent (40%) work, on average, a nine-to-ten hour day. A surprisingly large number (36%) work longer. Only 18%, a relatively small percentage, work the typical seven-to-eight hour day.

Table 2.1 **Hours Worked per Day**
In general, about how many hours a day do you devote to your business?

	%
Less than 7 hours/day	7
7 or 8 hours	18
9 or 10 hours	40
11 or 12 hours	25
More than 12	11
(Number of respondents)	(1047)

When asked about the number of days a week they work, a majority (60%) say they work five days. Significantly, however, one in every three chief executives devotes more than five days a week to his business.

Table 2.2 **Days Worked per Week**
How many days per week do you devote to your business?

	%
2 days/week	0
3 days	2
4 days	4
5 days	62
6 days	27
7 days	4
Don't know/No answer	1
(Number of respondents)	(1047)

The participants also were asked how many hours a day, realistically, they would like to devote to their businesses. Surprisingly, only one out of every three (33%) would like to cut work days down to less than seven hours, and one out of every four entrepreneurs (25%) would choose to work a longer day.

Table 2.3 **Hours per Day You Would Like to Work**
How many hours per day, realistically, would you *like* to devote to your business?

	%
Less than 7 hours/day	33
7 or 8 hours	42
9 or 10 hours	19
11 or 12 hours	5
More than 12 hours	1
(Number of respondents)	(1047)

When asked about the number of days they would like to work, a majority (63%) respond five days a week. Only 30% would choose a shorter week, and only 7% would choose to work more than five days.

Table 2.4 **Days per Week You Would Like to Work**
Again, how many days per week realistically would you like to devote to your business?

	%
1 day/week	0
2 days	1
3 days	6
4 days	16
5 days	63
6 days	5
7 days	1
Don't know/No answer	6
(Number of respondents)	(1047)

Observation
Although entrepreneurs enjoy limited leisure time, they are not necessarily eager to shorten work weeks in order to allow themselves more private time. The role of business is central in an entrepreneur's life. And if, as so many small business owners indicate, a primary incentive is personal fulfillment, it is understandable that few wish to withdraw from business commitments.

Stress and its Effects

The pressures exerted on the owner of a company are great. When asked how much work-related stress is experienced, better than one out of every three small business executives (37%) say they experience a great deal of stress. An additional 43% claim to experience a moderate amount of stress, 10% only a small amount, and 8% respond feeling none at all.

Table 2.5

Amount of Stress Experienced
A lot has been written recently on the amount of stress business people experience. Do you experience a great deal, a moderate amount, a small amount, or no stress related to work?

	%
Moderate amount	43
Great deal	37
Small amount	10
None at all	8
Don't know/No answer	1
(Number of respondents)	(1047)

Stress is most often associated with negative effects, but there can be a positive side. It can result in increased productivity and efficiency. The participants were asked how the stress they experience at work affects them personally. Only a small proportion, 22%, view stress as beneficial, while 43%, almost twice as many, view it as detrimental. Slightly less than one-third (32%) believe it has no effect at all on them Of the one-fifth who believe stress to be beneficial, a large majority (75%) claim that it makes their day-to-day life more interesting. Sixty-three percent (63%) state that stress increases their productivity, and 45% believe it helps them manage their time better.

Table 2.6

Effects of Stress
Do you believe the amount of business-related stress you experience is basically beneficial, detrimental or has no effect on you?

	%
Beneficial	22
Detrimental	43
Has no effect	32
Don't know/No answer	3
(Number of respondents)	(945)

Table 2.7 **Benefits of Stress**
How would you say this stress affects you personally?
[Asked of those who find stress *beneficial.*]

	%
Makes your day-to-day life more interesting	75
Increases your productivity	63
Helps you manage your time	45
Other	7
(Number of respondents)	(210)

Among the 43% who regard stress as detrimental, most (72%) claim it causes them to be irritable. The other two most common problems created by stress are difficulty with sleep (40%) and health problems (42%). A smaller percentage (29%) claim that work-related stress causes difficulties at home, and only 26% believe it reduces their productivity at work.

Table 2.8 **Problems of Stress**
How would you say this stress affects you personally?
[Asked of those who find stress *detrimental.*]

	%
Irritability	72
Health problems	42
Difficulty sleeping	40
Difficulties at home	29
Reduced productivity at work	26
Other	5
(Number of respondents)	(402)

The Family Provides Relief

Business and family do not constitute separate spheres for the entrepreneur. They are, quite the contrary, inextricably associated with each other. A large majority of the entrepreneurs are married — 85%. (The most recent U. S. census statistics report that nationally 67.8% of men and 62.4% of women 18 years of age and older are married.)

Table 2.9 **Marital Status**

	%
Married	85
Single	9
Other	5
Don't know/No answer	1
(Number of respondents)	(1047)

Family members play a large role in the businesses. Twenty-seven percent (27%) of the executives say their spouses work in their firms. More than one-third (36%) have at least one child working in their companies. About the same number (38%) have at least one other relative working in their firm.

Table 2.10 **Spouses Employed in the Business**
Does your spouse work in your business at all?

	%
Yes	27
No	73
(Number of respondents)	(1047)

Table 2.11 **Children Employed in the Business**
Do your children work in your business at all?

	%
Yes	36
No	64
(Number of respondents)	(1047)

Table 2.12 **Other Relatives Employed in the Business**
Do any of your other relatives work in your business at all?

	%
Yes	38
No	62
(Number of respondents)	(1047)

Not only are family members involved in the business, they have proved very supportive. Three out of every four (75%) owners also say their spouses were supportive when they first began their company or assumed their present position in the firm. Over half (58%) say their spouses were very supportive, while another 17% say they were somewhat supportive.

Table 2.13 **Level of Spouse's Support**
When you began in your business or assumed the position you now have in the firm, how did your spouse respond to the time demands made upon you by the business?

	%	
Very supportive	58	75%
Somewhat supportive	17	
Uninterested	3	
Apprehensive	4	
Resentful	6	
Was not married	10	
Don't know/No answer	2	
(Number of respondents)	(1047)	

The small business executive's children were also enthusiastic. Sixty-seven percent (67%) say their children have responded positively over the years.

Table 2.14 **Reaction of Children**
Over the years, how have your children responded?

	%
Very positively	45
Somewhat positively	22
Somewhat negatively	6
Very negatively	2
Neither positively nor negatively	6
Has no children	13
Don't know/No answer	6
(Number of respondents)	(1047)

When asked how their children revealed their positive responses, the most frequent indicator, chosen by 90% of business executives, is pride in their parent's positive image as a successful businessperson. The second most common response, chosen by 88%, is that the children valued highly the time spent together. When asked whether they believe their children valued the financial benefits resulting from their parent's position, 81% of the entrepreneurs answer yes. Only slightly more than half of small business owners (56%) say children expressed their positive responses by showing interest in working in the firm.

Of the entrepreneurs whose children showed a less than positive response, 35% say they tended to take too many things for granted.

Table 2.15 **Children's Positive Responses**
How would you say your children's positive response was shown?

	Yes	No	Don't Know/ No Answer
They were proud of your positive image as a successful business person	90	5	5
They valued highly the time you did have together	88	8	4
They valued the financial benefits	81	14	5
They showed interest in working in the business	56	39	6
(Number of respondents)	(701)		

Table 2.16

Children's Negative Responses
How would you say your children's less than positive response was shown?

	Yes	No	Don't Know/ No Answer
They tended to take too many things for granted	34	29	37
There was increased conflict in the home	25	41	34
You and your children have had a less close relationship than that in other families	25	36	39
They developed behavior problems	14	50	36
Other	6	8	86
(Number of respondents)	(142)		

Among the sacrifices entrepreneurs make, 45% always or often sacrifice leisure and vacation time, while fewer, 33%, always or often sacrifice time with family. Respondents rarely say they sacrifice other career options.

Table 2.17

Sacrificing Leisure Time, Family Time, and Other Career Options
How often do you feel that because of your commitment to your business:

	Always		Often	Some-times	Rarely	Don't Know/ No Answer
	%		%	%	%	%
You sacrifice leisure time and vacation time	16	|-45%-|	29	28	24	2
You sacrifice time with your family	10	|-33%-|	23	34	29	3
You sacrifice other career options	11	|-21%-|	10	22	49	8
(Number of resoondents)	(1047)					

The family also plays a crucial role in helping the entrepreneur deal with stress. When business executives are asked how they manage stress in a typical week, the most frequent response, 69%, is spending time with the family. Perhaps instead of dividing the family, stress can sometimes be used to unite it. Faced with the pressures of work, an entrepreneur is more likely to sacrifice his private leisure time than to sacrifice the time spent with the family.

About half of small business executives say that they use physical activity (60%), spending time with friends (59%), and resting or sleeping (55%) as additional ways to relieve stress. The possibilities chosen least frequently are taking medication (12%), drinking or smoking (30%), and eating (35%).

Table 2.18 **Dealing with Stress**
In which of the following ways do you manage stress in a typical week?

	%
Spend time with family	69
Engage in physical activity	60
Spend time with friends	59
Rest or sleep	55
Read	51
Watch television	44
Travel on days off	39
Eat	35
Drink or smoke	30
Take medication	12
Hobbies	4
Other	1
Don't know/No answer	3
(Number of respondents)	(945)

Observation
Compared to those who consider it beneficial, twice as many small business owners view stress as detrimental. In response to that stress, which respondents note produces irritability, loss of sleep, and medical problems, among others, respondents choose coping behavior which is by most standards clearly beneficial — time with family, and friends, and physical activity, far more often than less obviously healthy activities such as drinking, smoking, or taking medication. Small business owners also spend time with family by employing children, spouses and other relatives, relieving work stress by integrating family into work contexts.

Is It Worth It? Yes

In investigating attitudes toward business ownership, the participants in the survey were first asked if, in retrospect, they would again choose to operate a business. An overwhelming majority (91%) respond affirmatively. Even more impressive is that 80% say they would definitely again make that choice, while 11% answer they probably would. Most entrepreneurs view their careers, despite the amount of work and the risks entailed, as a satisfying and worthwhile venture.

Table 2.19 **Would You Do It Again?**
In retrospect, would you again choose to own your own business?

	%	
Definitely	80	91%
Probably	11	
Probably not	3	7%
Definitely not	4	
Don't know/No answer	1	
(Number of respondents)	(1047)	

Heads of small businesses were then asked to single out the most compelling reason, in their opinion, to start or own a business.

Almost four in ten (38%) single out the freedom of being one's own boss as the most compelling reason. About a quarter of the executives claim that financial benefits (25%) and personal fulfillment (24%) are of singular importance.

Table 2.20 **Why Own Your Own Business?**
What would you say is the single most compelling reason to start or own your own business?

	%
Freedom of being one's own boss	38
Financial benefits	25
Personal fulfillment	24
Family tradition	8
Other	1
Don't know/No answer	4
(Number of respondents)	(1047)

When asked whether they believe there are significant benefits they have relinquished by owning their own businesses, a majority, 60%, reply in the negative. A significant minority (37%) do believe, however, that there are benefits they have lost. Most commonly missed is regular working hours (28%), and 22% say they miss vacation time.

Table 2.21 **Have You Given Up Benefits by Working for Yourself?**
Are there significant benefits in working for someone else that you feel you have given up?

	%
Yes	37
No	60
Don't know/No answer	3
(Number of respondents)	(1047)

Table 2.22 **Benefits Given Up**
Many salaried employees have the following benefits. Which *one* do you think you have missed the most?

	%
Regular hours	28
Vacation time	23
Pension/retirement program	12
Job security	5
Group medical insurance	3
Less responsibility	1
Other	2
Don't know/No answer	27
(Number of respondents)	(1047)

The entrepreneurs were asked to judge whether on balance the rewards involved in owning a business justified the financial risks inherent in any business undertaking. An overwhelming majority (87%) respond in the affirmative.

Table 2.23 **Rewards vs. Financial Risk**
On balance, do you think the rewards involved in owning one's own business justify the financial risks?

	%
Yes	87
No	9
Don't know/No answer	4
(Number of respondents)	(1047)

But for Your Children?

Six in ten of the small business leaders (60%) would like to see their enterprises continued in roughly their present form after they retire. Forty-three percent (43%) say they would like their companies to be continued by someone else, and another 18% say they would prefer to sell their business to another entrepreneur at their retirement. Only about one in ten (11%) say they would prefer to sell their business to a large corporation. Regardless of their preferences, only about one in three (34%) of these business people have made any preparations for the future transfer of management or ownership of their company.

Table 2.24

Plans After Retirement
What would you prefer to do with your business when you retire?

	%	
Have it continued by someone else	42	60%
Sell it to another entrepreneur	18	
Sell it to a large corporation	11	
Keep it in the family	5	
Close it down	4	
Something else	1	
Don't know/No answer	18	
(Number of respondents)	(1047)	

Table 2.25

Plans for Future of the Company
In thinking of the future of your company, have you made any preparations for transfer of management or ownership?

	%
Yes	34
No	65
Don't know/No answer	1
(Number of respondents)	(1047)

Although it might be expected that successful entrepreneurs want their children to inherit the business, three in ten (30%) would recommend they enter a profession. Only eighteen percent (18%) would recommend that their children go into their own businesses, while 16% would recommend that their children start their own.

Table 2.26 **Recommendations to Their Children**
Ideally, would you recommend your children to:

	%
Enter a profession	30
Go into *your* business	18
Start their own business	16
Work for another business	6
Decide for themselves	4
Don't know/No answer	25
(Number of respondents)	(1047)

According to 46% of the respondents, their children would choose to work elsewhere than in their parents' businesses. One in five (19%) say their children would prefer to enter their business, but almost a third say they don't know what their children would prefer.

Table 2.27 **What the Children Prefer**
Which do you think your children would prefer:

	%
Something else	46
Go into *your* business	19
Has no children	4
Don't know/No answer	31
(Number of respondents)	(1047)

If their children were to work for another company, more small business executives would recommend that it be a large rather than a small firm. Four out of ten entrepreneurs (39%) say they would recommend working in a large business, compared to only 29% recommending a small business.

Table 2.28 **What Kind of Business the Children Should Work In**
If your child were to work for another business, would you recommend he or she work for a large business or a small business?

	%
Large business	39
Small business	29
Don't know/No answer	32
(Number of respondents)	(1047)

Observation

In this study the family emerges as an integral component of many businesses and as the most important outlet for work stress for the business owner. Business responsibilities do not lead to sacrificing time with family as much as they do to the sacrifice of leisure and vacation time.

The ultimate test of satisfaction — the owners' assertion that they would do it again if they could — clearly demonstrates that these people are well-matched to their career goals and ambitions. There is, however, one important note of ambivalence: only one in five would like their children to go into their businesses and even fewer would like to see their children become owners of another business. Furthermore, they show a slight preference, regarding their children's employment, for large business over small business. The business owners display the traditional desire to maintain increased aspirations for one's offspring: what's good enough for them may not be good enough for their children.

SMALL
BUSINESS
SPEAKS

Chapter III

The Business Neighborhood

Introduction Crime leads the list of local concerns for the New York metropolitan area entrepreneur. Small business owners are also quite concerned about the cost and quality of the urban environment. They do not see their local public sector agencies as doing a good job in meeting their needs: neither public education nor government receive good ratings. The owners themselves, however, are not at all likely to be involved in any effort to address the local problems that concern them.

One in five small business owners expect to relocate in the next two years, but among those only 21% expect to leave the metropolitan area. Local problems do not appear to be a major reason for relocation. By contrast, the firm's own expansion, space needs, and space costs are the prime reasons for relocating.

What Needs Attention

The small business person in the New York metropolitan area is mostly concerned about safety, and secondarily about what has been called the most precious ingredient of urban life, space (cost of commercial space, congestion in the streets, cleanliness of the neighborhood). Coupled with these is a perception that local government is not doing the job that it should be.

Table 3.1 **Local Problems Needing Immediate Action**

I am going to ask you about some issues that might need attention in your area. In your opinion, which need immediate attention and which are manageable problems in your business's area?

	Needs Immediate Attention	Problem Is Manageable	Don't Know/ No Answer
	%	%	%
Crime	55	43	3
Cost of commercial space	38	57	5
Traffic congestion or parking	35	61	4
Neighborhood cleanliness	33	64	3
Deteriorating neighborhoods	30	65	5
Lack of government support	29	62	9
Unemployment	25	66	8
Availability of commercial space	24	70	6
Public transportation	21	74	5
Residential housing costs	20	67	13
Inflexible zoning ordinances	13	75	12
Water and air quality	10	85	5
Other	2	3	95
(Number of respondents)	(1047)		

When small business people in the New York metropolitan area are asked to select the single local issue most in need of attention, crime again leads the list, followed by cost of commercial space

Table 3.2

Most Important Local Problem
Of these local area concerns you think need the most attention, which do you think is the *single most critical* factor needing immediate attention?

	%
Crime	25
Cost of commercial space	13
Traffic	9
Unemployment	5
Lack of local government support	5
Deteriorating neighborhoods	5
Public transportation	5
Inflexible zoning ordinances	3
Availability of commercial space	3
Residential housing costs	2
Cleanliness	2
Water and air quality	1
Don't know/No answer	24
(Number of respondents)	(1047)

The urban counties in the New York metropolitan area are considerably more concerned about crime and about the cost of commercial space than are the suburban counties. Nearly three in ten (28%) of the businesses in urban counties cite crime as the problem most in need of attention, compared with only 18% of those in suburban counties. Likewise, about one in six (17%) business people in the urban counties say that the cost of commercial space is the number one problem, compared with only 3% of those in the suburban counties. On the other hand, 13% of business people in the suburban counties say that traffic congestion and parking is the problem most in need of attention, while surprisingly only 7% of the business people in the urban counties feel this way.

Table 3.3

Most Important Local Problem by County Type
What is the single most critical factor needing immediate attention in your area?

	All Respondents	Urban	Suburban
	%	%	%
Crime	25	28	18
Cost of commercial space	13	17	3
Traffic	9	7	13
Unemployment	5	6	5
Deteriorating neighborhood	5	4	5
Public transportation	5	5	3
Lack of government support	5	3	7
Inflexible zoning ordinances	3	1	6
Availability of commercial space	3	4	2
Water and air quality	2	1	1
Residential housing costs	2	1	5
Cleanliness	2	2	1
Don't know/No answer	24	20	29
(Number of respondents)	(1047)	(736)	(311)

Table 3.4 **Most Important Local Problem by County**
What is the single most critical factor needing immediate attention in your area?

	All Respondents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Westchester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Crime	25	24	39	31	53	25	24	7	11	20
Cost of commercial space	13	24	2	4	4	4	6	7	2	2
Traffic	9	7	7	8	2	5	14	12	13	13
Unemployment	5	6	4	8	4	7	6	10	6	4
Deteriorating neighborhood	5	3	8	5	12	5	6	3	3	6
Public transportation	5	6	6	1	2	2	3	3	7	1
Lack of government support	5	2	4	8	4	5	6	9	9	7
Inflexible zoning ordinances	3	0	2	2	4	5	4	7	8	7
Availability of commercial space	3	5	1	4	4	4	4	5	0	2
Water and air quality	2	1	0	3	2	9	0	0	3	1
Residential housing costs	2	2	0	1	0	0	5	5	9	3
Cleanliness	2	1	4	2	2	2	2	0	1	1
Don't know/ No answer	24	20	23	24	8	25	21	31	28	33
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Observation

Crime and commercial space are policy priorities in urban counties, and traffic congestion is a priority in suburbs, suggesting that no single comprehensive public policy solution can be formulated for small businesses throughout the metropolitan area. Local variations in community problems require distinct approaches to help resolve them.

Low Marks for Public Education

Public education is an issue of great national concern. Business owners find it inadequate in many ways. As seen in Chapter One, finding qualified personnel as employees is one of the major concerns of small business in the area. In addition almost three-quarters of small business owners (73%) say that the public education system does not provide skills and training for business ownership or management. Only 18% believe that it does.

Table 3.5

Public Education
In your opinion, does the public education system provide skills and training for business ownership or management?

	%
Yes	18
No	73
Don't know/No answer	9
(Number of respondents)	(1047)

Over half of New York entrepreneurs (55%) believe that on-the-job training or work experience best prepares one for business ownership and only 22% say college education is the best preparation. Apparently, although respondents believe formal public education does provide little to develop business talent, they do not consider that deficiency a nagging problem, since on-the-job experience is considered the best preparation for business ownership in any case.

Table 3.6

The Best Preparation for Business Ownership
In your opinion, which type of training *best* prepares one for business ownership or management? Which is second best and which is third best?

	First Best	Second Best	Third Best
	%	%	%
On-the-job training or work experience	55	24	12
College education	22	31	22
A master's degree in business administration	12	13	22
Vocational training	5	20	24
(Number of respondents)	(1047)		

SMALL BUSINESS SPEAKS

Dissatisfaction with County Government

County governments do not receive a high rating from entrepreneurs, but suburban businessmen rate their local governments more highly than do their urban counterparts.

Only one in five (21%) owners and top executives of metropolitan area small businesses say that their local county/borough government is doing an excellent or good job in fostering a good climate for businesses such as theirs. A full 66% say that their local government is doing a fair or poor job.

Business people in the suburban counties are much more satisfied with their local governments than are those in the urban counties. Three in ten (32%) of those in suburban counties, compared with only 17% of those in urban counties, say that their local government is doing an excellent or good job in fostering a good climate for small business.

Nassau (37%) and Suffolk (33%) small business owners are more likely than those in the other counties to say that their local governments are doing a good job. Despite their high level of concern about crime, and in addition to their high level of involvement in programs dealing with local problems, the business people in the Bronx are more likely than those in any other New York City county to say that their county government is fostering a good climate for business such as theirs. On the other hand, along with their high concern about the cost of commercial space, the small business people of Manhattan are the least likely of those in all the counties surveyed to say that their county government is doing a good job.

Table 3.7 **Evaluation of County Government by County Type**
How would you rate the job the county/borough government is doing to foster a good climate for businesses like yours?

	All Respondents		Urban		Suburban	
	%		%		%	
Excellent	3	21%	3	17%	4	32%
Good	18		14		28	
Fair	33	66%	31		38	
Poor	33		37		24	
Don't know?/No answer	13		15		7	
(Number of respondents)	(1047)		(713)		(334)	

Table 3.8 **Evaluation of County Government by County**

How would you rate the job the county/borough government is doing to foster a good climate for business like yours?

	All Respondents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	West-Chester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Excellent	3	2	4	4	2	7	3	2	4	4
Good	18	12	16	16	27	18	22	16	29	32
Fair	33	33	29	26	24	38	45	26	33	38
Poor	33	36	40	36	41	24	24	47	27	19
Don't know/ No answer	13	16	11	18	6	13	6	10	7	7
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Inactivity in Community Affairs

Only a small minority of local owners are involved in dealing with the problems they identify as most needing immediate attention in their local areas. The majority (52%) report they are not at all involved in any local activity, and nearly a fifth (21%) do not supply an answer. Suburban businesses are slightly more involved in local efforts to solve community problems than are urban businesses.

Business people in Staten Island and the counties north of Manhattan report being somewhat more involved in community efforts dealing with local problems. About one-quarter of those in Westchester (26%) and Staten Island (24%) say they are very or somewhat involved, compared with about one in five of those in Rockland (21%) and the Bronx (20%). Manhattan businesses are least involved in efforts dealing with local problems—only 12% say they are very or somewhat involved. Low levels of local issue involvement are characteristic of small business people in the metropolitan area.

Table 3.9 **Involvement in Local Problems by County Type**

How involved if at all is your company in any local program dealing with this problem?

	All Respondents	Urban	Suburban
	%	%	%
Very involved	6	6	7
Somewhat involved	9	8	12
Slightly involved	9	9	9
Not at all involved	54	58	44
Don't know/No answer	21	18	28
(Number of respondents)	(1047)	(736)	(334)

SMALL BUSINESS SPEAKS

Table 3.10

Involvement in Local Problems by County
How involved if at all is your company in any local program dealing with this problem?

	All Respondents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Westchester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Very involved	6	5	7	8	10	11	10	7	9	3
Somewhat involved	9	7	10	8	10	13	16	14	8	13
Slightly involved	9	8	11	12	20	11	8	14	9	10
Not at all involved	54	61	51	54	53	44	44	36	47	43
Don't know/ No answer	21	19	21	18	8	22	22	29	27	32
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Staying in the New York Area

Despite disappointment in county government and little involvement in local issues, few entrepreneurs have been so alienated that they seriously consider moving out of the area.

Nearly one in five (18%) of area small business owners report that it is likely they will relocate within the next two years. Small businesses in Rockland and Queens, and to a lesser extent Manhattan and Nassau, are the most likely to expect to relocate. Small business people in urban counties are no more likely to consider relocating than are their counterparts in suburban counties.

Table 3.11

Business Likely to Relocate Within Two Years
Is it likely that you will relocate your business within the next two years?

	All Respondents	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Westchester	Rockland	Suffolk	Nassau
	%	%	%	%	%	%	%	%	%	%
Yes	18	20	16	22	16	13	12	29	12	19
No	64	67	66	48	53	67	61	45	75	66
Don't know/ No answer	17	13	18	30	31	20	27	26	13	16
(Number of respondents)	(1047)	(309)	(100)	(114)	(51)	(55)	(109)	(58)	(116)	(135)

Table 3.12 **Businesses Likely to Relocate Within Two Years by County Type**

Is it likely that you will relocate your business within the next two years?

	All Respondents	Urban	Suburban
	%	%	%
Yes	18	19	16
No	64	64	66
Don't know/No answer	17	17	18
(Number of respondents)	(1047)	(736)	(311)

Almost one-quarter (22%) of the companies expecting to relocate say they will be moving into Mannattan. Another one in five (21%) expect to leave the nine-county area.

Table 3.13 **Relocation Destinations**

	%
Manhattan	23
Outside the nine-county area	21
The Bronx	10
Nassau	9
Suffolk	3
Westchester	3
Brooklyn	1
Staten Island	1
Rockland	1
Queens	0
Don't know/No answer	29
(Number of respondents)	(190)

High rent is the reason for relocating cited most frequently (by 25%) by those expecting a move. This is consistent with the business executives' identification of the cost of commercial space as one of the major local problems they face. Crime, however, the number one local problem, is cited by only 3% as the reason for their relocation. Perhaps crime, the number one concern, has been gradually "accommodated to" over time, becoming an accepted "cost of doing business," rather than a critical balance-sheet deficiency.

Table 3.14 **Reasons For Relocating**

What are the one or two main reasons why you are thinking about relocating?

	%
High rent	25
Lack of space	14
Taxes	14
Need to expand	12
Commuting/location	12
Financial reasons	10
Crime	
Other (miscellaneous)	21
(Number of respondents)	(196)

Observation

This review of small business executives in their local environments reinforces the profile of entrepreneurs as absorbed in business and family. Public education is judged to be of relatively little use to owners. Crime, the cost of commercial space and neighborhood environmental quality are all of concern, but despite these dilemmas few small business owners are involved in civic programs which address the problems in the communities where their businesses are located. Nor do substantial numbers of business people consider leaving the region. Most are committed to the metropolitan area.

These findings suggest that a healthier business environment would result if public and private institutions were to address the problems of crime, cost of space, and neighborhood quality. Given the findings about the enormous personal demands on their time, their stress on the primary importance of the family and their low levels of public commitment, small business owners would not become involved in such activities unless major efforts were made to change their perspectives on the personal value of public involvement.

SMALL BUSINESS SPEAKS

Chapter IV

Banks and Trade Associations: How Helpful Are They?

Introduction On the whole, small business owners in the New York metropolitan area give mixed reviews to the institutions and industries that provide support services to them. While many feel their banks provide adequate support, a majority say they receive less than satisfactory service. The survey findings also suggest that some key bank programs designed to help small businesses, such as industrial development bond programs, are poorly understood by the small business community. Lastly, the findings suggest that trade associations are an important though frequently overlooked source of support for small business, supplying information about marketing and general business concerns, providing important business contacts, and providing representation in government lobbying efforts.

A Challenge to Banks

Most heads of small businesses in the New York metropolitan area do not think they are among the major interests of financial institutions. Only 1% of business people say they believe banks are more interested in small business than in large business. But the majority (65%) believe that banks are more interested in big business. Another 25% say they believe banks are equally interested in large and small businesses.

Table 4.1 **Are Banks Interested in Small Business?**
Do you believe banks are:

	%
More interested in big business	65
Equally interested in both	25
More interested in small business	1
Don't know/No answer	8
(Number of respondents)	(1047)

Even though relatively few small business people think that smaller businesses are a priority for banks, nearly four in ten (37%) say that banks are doing a good (26%) or excellent (11%) job in providing financial services to businesses like their own. About half (52%) of the business people, however, say that banks are doing a fair (27%) or poor job (25%).

Table 4.2 **Performance of Banks**
How would you rate the job banks are doing in providing financial services to businesses like yours?

	%	
Excellent	11	37%
Good	26	
Fair	27	52%
Poor	25	
Don't know/No answer	11	
(Number of respondents)	(1047)	

About half (52%) of the small business people in the area say a banker has visited them personally within the last year. A full 25% last had a visit from their banker more than one year ago, and 21% report that they have never been personally visited by a banker.

Table 4.3 **Visits from Bankers**
How long has it been since a banker visited you personally?

	%	
Within the last six months	39	52%
Within the past year	13	
Within the past two years	5	
Two years ago or more	21	
Never	21	
Don't know/No answer	2	
(Number of respondents)	(1047)	

The biggest complaint that the area business people express concerning banking is a criticism that reflects on both their banks and their accountants. Forty-five percent (45%) strongly agree that there ought to be more coordination between banks and accountants who serve small businesses.

Three other complaints occur about as frequently. About four in ten (39%) strongly agree that banks should contact them more frequently to discuss their business needs. Another four in ten (38%) small business executives strongly agree that most banks need to be faster in responding to their credit requests. And 36% say that most banks do not provide enough personal attention to small businesses.

Table 4.4 **Negative Perceptions of Banks**
Please tell me whether you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the following statements.

	Agree Strongly	Agree Somewhat	Disagree Somewhat	Disagree Strongly	Don't Know/ No Answer
There needs to be more coordination between banks and accountants who serve small business.	45	28	9	6	12
Banks should contact you more frequently to discuss your business needs.	39	23	19	13	6
Most banks need to be faster in responding to your business's credit request.	38	23	14	11	12
Most banks don't provide enough personal attention to businesses like your own.	36	22	18	16	8
(Number of respondents)	(1047)				

Table 4.5 **Positive Perceptions of Banks**
Please, tell me whether you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the following statement.

	Agree Strongly	Agree Somewhat	Disagree Somewhat	Disagree Strongly	Don't Know/ No Answer
When your primary contact at the bank is not available, there is usually someone else who can help you.	37	28	11	19	4
Banks generally meet the credit needs of business like yours.	27	33	12	17	11
Bank officers assigned to commercial accounts generally are knowledgeable about the needs of businesses like yours.	26	35	13	19	7
(Number of respondents)	(1047)				

Finding Money to Grow

Industrial development bonds provide low-interest financing for capital expansion. Only one in four (23%) of the small business executives in the New York metropolitan area say they are very or somewhat familiar with this form of financing. Over half (57%) say they are not at all familiar with the bonds.

Table 4.6 **Familiarity with Industrial Development Bond Programs**
How familiar are you with municipal or county low-rate industrial development bonds?

	%	
Very familiar	7	23%
Somewhat familiar	16	
Slightly familiar	19	
Not at all familiar	57	
Don't know/No answer	1	
(Number of respondents)	(1047)	

Of those who are at least somewhat familiar with industrial development bonds, half (53%) say they are very or somewhat interested in industrial development bond programs. A third (33%) say that such programs meet the needs of companies like their own very or somewhat well.

Table 4.7 **Interest in Industrial Development Bond Programs**
[Base: the 25% "familiar" with industrial development bonds.]
How interested are you in industrial development bond programs which provide low-interest financing for capital expansion?

	%	
Very interested	32	53%
Somewhat interested	21	
A little interested	11	
Not at all interested	34	
Don't know/No answer	2	
(Number of respondents)	(248)	

Table 4.8 **Usefulness of Industrial Bond Programs**
[Base: the 25% "familiar" with industrial development bonds.]
How well do they meet the needs of companies like yours?

	%	
Very well	10	33%
Somewhat well	23	
Not very well	15	
Not at all	36	
Don't know/No answer	15	
(Number of respondents)	(248)	

One in five (20%) of the business people say they are familiar with other programs for low-rate capital financing. When these people were asked to identify what programs they are familiar with, more (40%) mentioned Small Business Association loans than any other program.

Table 4.9 **Familiarity with Other Financing Programs**
How familiar are you with other programs for low-rate capital financing?

	%	
Very familiar	4	20%
Somewhat familiar	16	
Slightly familiar	22	
Not at all familiar	55	
Don't know/No answer	2	
(Number of respondents)	(1047)	

Table 4.10 **Familiarity with Specific Programs**
[Base: the 20% "familiar" with low-rate capital financing programs.]
Which low-rate capital financing are you familiar with?

	%
Small Business Administration loans	40
Federal government program	26
Job development authority	15
Urban development grant	10
State or local program	9
Bank program	7
Other	7
Don't know/No answer	4
(Number of respondents)	(208)

Observation

Small business owners are not fully satisfied with the services they receive from banks, and it is clear that banks can be doing a great deal more than they are doing now to support small business. Part of the problem is that banks have not done a good job in informing small business owners about some of the programs, such as the low-rate financing programs, that are available.

But the main problem — expressed clearly by the survey respondents — is that banks have tended to overlook the needs of small businesses in favor of other business segments. Nearly two out of three small business owners feel banks are more interested in large businesses, and nearly 60% believe that most banks do not provide enough attention to small business.

SMALL BUSINESS SPEAKS

Simply spending more time understanding their needs, and providing more personal service by qualified calling officers, is an important first step toward better serving the small business community. But this will not be enough. The survey suggests that small businesses need greater accessibility to reasonably priced financing, faster response to credit requests, closer coordination between their banks and their accountants, and a variety of non-credit services to help them perform better during difficult economic conditions. These financially-related needs, sometimes overlooked in the past, stand as a clear challenge to the banking community in the New York metropolitan area.

Trade Associations: Old and New Roles

A majority (60%) of the small business people in the New York metropolitan area say their trade associations are important to them.

Table 4.11 **Importance of Trade Associations**
How important are trade associations in your industry?

	%	
Very important	33	60%
Somewhat important	27	
Fairly unimportant	13	
Not at all important	24	
Don't know/No answer	2	
(Number of respondents)	(1047)	

Of the entrepreneurs who say their trade associations are important, most (81%) say the associations are helpful in providing general business information. A majority also say their associations are helpful in providing marketing information (63%), as sources of business contacts (54%), and in lobbying efforts (53%).

Table 4.12 **Areas Where Trade Associations Help**
In which of the following areas are your trade associations helpful?

	Yes	No	Don't Know/ No Answer
	%	%	%
General business information	81	16	3
Marketing information	63	33	4
Source of business contacts	54	43	2
Lobbying efforts	53	42	5
Group plans such as group insurance	47	49	4
Financing information	28	66	6
Other	9	19	72
(Number of respondents)	(629)		

When asked in which areas they would like to see their trade associations play a more active role, about half (59%) made a specific suggestion. Fourteen percent (14%), however, say that lobbying is an area in which they would like to see their trade associations be more active.

Table 4.13 **Where Trade Associations Can Help More**

In which areas would you like trade associations to play a more active role?

	%
Lobbying	14
Marketing information	11
Financing information	9
General business information	8
Business contacts	4
Government and regulatory information	2
Credit information	2
Group plans	2
Other	9
Don't know/No answer	41
(Number of respondents)	(629)

Observation

Trade associations play a more important role for small businesses than is generally realized. Though often viewed primarily as lobbying organizations, trade associations are a key source of information and business contacts for large numbers of New York area small business owners. Many others rely on trade associations for providing discounted services such as group insurance. The main implication here for government agencies, the financial services industry, and other groups serving small business is that associations provide a well-established, trusted channel through which some small business needs may be met.

Chapter V

Counting On The Accountant

SMALL BUSINESS SPEAKS

Introduction

A small business owner's most important advisor is his accountant. Accountants have close working relationships with small business owners, and are chosen on the basis of personal trust and confidence—not especially for the accountant's status, prestige, or special expertise. This close alliance between accountants and small business owners can be seen in their similarly-shared views on the economy, problems facing small business, and in attitudes toward the government.

The Crucial Role

When entrepreneurs on the New York metropolitan area have to make a business decision, they are most likely to turn first to their accountant for advice and information. About half (54%) say they turn to their accountant first, while only about one in ten or less say they turn to any other one advisor. Eleven percent (11%) say they turn first to a trusted personal advisor, 10% to their lawyer, and 9% to their spouse.

Table 5.1

Who Is Turned to for Advice
If you have to make a important business decision, to which outside source would you turn to first for advice and information?

	%
Your accountant	54
A trusted personal advisor	11
Your lawyer	10
Your spouse	9
Your industry or trade association	6
Your banker	4
Other	1
Don't know/No answer	5
(Number of respondents)	(1047)

Accountants are most helpful to business people in the analysis of financial statements (75%) and in tax planning (73%). About half (53%) also say that their accountant helps them understand their business's performance. It is important to note that only one in five (21%) say that their accountant is helpful on the selection of a bank, while, as noted previously, the most frequently cited complaint about banks is the lack of coordination between banks and accountants.

Table 5.2 **How the Accountant Helps**
In what ways does your accountant help you run your business more effectively?

	%
In the analysis of financial statements	75
In tax planning	73
In helping you understand your business's performance	53
With advice on systems for better management information	35
In locating equity	35
In structuring loans	33
In selecting a bank	21
Not at all	1
In everything	1
Personal finances	1
Other	2
Don't know/No answer	0
(Number of respondents)	(1047)

The most important characteristic in choosing an accountant is the owner's personal trust and confidence in the individual. This factor is mentioned by four in ten (39%) business people as most important. Similarly, 20% of small business owners cite a personal recommendation from a friend or associate as the most important factor. Nearly as important as a personal recommendation, cited by 17% of the business people, is that the accountant have expertise in tax planning.

Table 5.3 **Factors in Choosing an Accountant**
What was the most important factor in your choice of an accountant?

	Most Important
	%
Personal trust and confidence	39
Recommendation of a friend or associate	20
Expertise in tax planning	17
His local reputation	5
Access to a senior level partner	5
His fee	2
His clout with the banks	2
(Number of respondents)	(1047)

Accountants and Small Business

Since the accountant plays such a crucial role in the small business executive's life, it is important to see where accountants agree and disagree with their clients.

Accountants nearly unanimously believe that they help executives run their firms in a wide variety of ways. Three-quarters (76%) of the owners say that accountants help them in the analysis of financial statements; 99% of the accountants agree. While only 34% of the executives say they benefit from accountants in structuring loans, 92% of the accountants claim they aid small business owners in that area.

Table 5.4

How Accountants Say They Help Small Business
In what ways does an accountant help smaller businesses run their firms more effectively?

	%
In tax planning	99
in the analysis of financial statements	99
In structuring loans.	92
In helping to understand the business's performance	90
With advice on systems for better management information	85
In locating equity	77
In selecting a bank	72
(Number of respondents)	(1047)

Observation

To a considerable extent, small business owners and accountants agree on the main ways in which accountants provide support: tax planning, the analysis of financial statements, and in helping to understand financial performance. Interestingly, however, there is a large disparity between the two groups in acknowledging the role accountants can play in providing such assistance as advice on management information systems and help in structuring loans or on selecting a bank.

It may be that accountants, in spite of the strong and positively viewed role they play, can perform more functions, and provide a wider range of services than they do now. There is considerable opportunity for accountants to expand their involvement in the small business community.

According to accountants, the single most important factor in a small business person's choice of an accountant is the recommendation of a friend or associate.

Table 5.5 **Important Factors in Choosing an Accountant**
What are the most important factors in the small business person's choice of an accountant?

	Most Important %
Recommendation of a friend or associate	32
Personal trust and confidence	28
Expertise in tax planning	15
The fee	13
The accountant's local reputation	9
Access to a senior level partner	1
Clout with the banks	1
Don't know	1
(Number of respondents)	(79)

Accountants on National Issues Affecting Small Business

Accountants who serve small businesses disagree with the majority of New York area entrepreneurs on two national economic indicators. A significant majority (68%) of the accountants predict that interest rates will go up over the next twelve months. Only about half (52%) of small business executives share that view. A majority (56%) of the accountants also say that the inflation rate will go up over the next twelve months, compared with only 47% of business people.

Table 5.6 **Accountants on Interest Rates**
Do you think interest rates over the next twelve months will:

	%
Go up	68
Go down	11
Hold steady	18
Don't know	3
(Number of respondents)	(79)

Table 5.7 **Accountants on Inflation**
Do you think inflation over the next twelve months will:

	%
Go up	56
Go down	6
Hold steady	37
Don't know	1
(Number of respondents)	(79)

The accountants and the small business executives also agree that the present economic climate as it affects smaller businesses is fair to poor.

Table 5.8

Accountants on The Economic Climate
How would you rate the present economic climate as it affects the smaller businesses that you work with?

	%
Excellent	0
Good	30
Fair	52
Poor	18
(Number of respondents)	(79)

The accountants also agree with the small business people that the three issues entrepreneurs worry most about are interest rates, inflation, and taxes.

Table 5.9

Accountants on Small Business's Greatest Concerns
What natonal economic factors do the small business people that you work with worry about the most?

	%
Interest	77
Inflation	63
Taxes	60
Unemployment	19
Ability of American business to compete worldwide	11
Regulation	8
The federal deficit	5
(Number of respondents)	(79)

However, the accountants are somewhat more likely to believe that small businesses have felt the impact of the economic upturn. Half (50%) of the accountants say small business in the New York area has definitely or somewhat felt the upturn, compared with only 39% of the entrepreneurs themselves.

Table 5.10

Accountants on Economic Upturn for Small Business
Have these smaller businesses that you deal with felt the impact of the economic upturn?

	%	
Definitely	17	50%
Somewhat	33	
Only slightly	27	
Not at all	24	
Don't know	0	
(Number of respondents)	(79)	

SMALL BUSINESS SPEAKS

Accountants and small business owners have somewhat different opinions as to the factors most likely to limit the possible growth of small businesses. The executives single out tight consumer spending (36%), the cost of energy (35%), and the difficulty in finding qualified personnel (34%) as being very likely to limit growth. However, accountants most frequently select the cost (51%) and the availability (44%) of financing as very likely to limit growth.

Table 5.11 **Accountants on Factors Which May Limit Small Business Growth**

I am going to read through a list of factors which can limit the growth of some businesses. For each one tell me whether it is very likely, somewhat likely, or not at all likey to limit the growth of the smaller businesses you deal with.

	Very Likely	Somewhat Likely	Not at All	Don't Know/ No Answer
	%	%	%	%
Cost of financing	51	35	14	0
Availability of financing	44	39	17	0
Tight consumer spending	29	39	27	5
Finding qualified personnel	25	46	29	0
Increased competition from businesses the size of yours	25	42	32	1
Competition from large businesses	24	39	34	3
Personnel costs	20	56	24	0
Federal and state corporate income tax	19	39	42	0
Local taxes	19	42	39	0
Cost of energy	15	48	34	3
Technological change	14	39	42	5
Government regulation	10	44	43	3
Foreign competition	9	28	59	4
Cost of insurance	6	34	60	0
Competition from street vendors or local flea markets	3	13	82	2
(Number of respondents)	(79)			

Observation

These differences of opinion between small business owners and their accountants largely relate to the different perspectives each has of the business. Financially oriented as they are, accountants see the cost and availability of credit as potentially most limiting. Businessmen, concerned about day-to-day operating problems, place stronger emphasis on personnel issues and energy costs.

Both groups are in agreement, however, that tight consumer spending—a characteristic of the recessionary economy still affecting the small business sector—is a major factor likely to limit the growth of small businesses in the period ahead. This is yet another piece of evidence that many area businesses have not yet felt the full impact of the national economic recovery.

Accountants agree with small business owners that small businesses generally do not get a fair hearing in government on the county, state, and national levels.

Table 5.12 **Accountants on Government and Small Business**
In your perception, do smaller businesses get a fair hearing in government?

	Yes	No	Don't Know/ No Answer
	%	%	%
On the county/borough level	29	52	19
In Albany	24	58	18
Nationally	18	64	18
(Number of respondents)	(79)		

Accountants also are in strong agreement with business people that the public education system does not provide skills and training for business ownership and management. Likewise, the accountants agree that the best type of training for small business ownership is on-the-job training or work experience.

Table 5.13 **Accountants on Public Education as Preparation for Business**
In your opinion, does the public education system provide skills and training for business ownership or management?

	%
Yes	14
No	84
Don't know	2
(Number of respondents)	(79)

Table 5.14 **Accountants on Best Preparation for Business Ownership or Management**
In your opinion, which type of training *best* prepares one for business ownership or management, which is second best, and which is third best?

	Best
	%
On-the-job training or work experience	67
College education	19
A master's degree in business administration	10
Vocational training	3
Don't know	1
(Number of respondents)	(79)

SMALL BUSINESS SPEAKS

Accountants confirm the entrepreneurs' perception that small business today experiences the same amount of government regulation as was felt before President Reagan came into office.

Table 5.15 **Accountants on Small Business Regulation**
Would you say that these smaller businesses are today experiencing less, the same, or more government regulation than they did before President Reagan came into office?

	%
Less regulation	14
The same amount	62
More regulation	24
(Number of respondents)	(79)

Accountants are slightly less optimistic than business people about the potential of small businesses to contribute to the country's future economic growth. Thirty-two percent (32%) of the accountants believe that small businesses have more potential today than in the past, compared with 40% of entrepreneurs.

The accountants are in agreement with the owners that the entrepreneurial spirit in America in recent years has declined and that the best way to stimulate the entrepreneurial spirit would be easier financing for new businesses.

Table 5.16 **Accountants on Small Business Potential**
Do you feel small businesses have as much potential today as in the past to contribute significantly to the country's future economic growth?

	%
More today	32
Less today	25
The same	38
Don't know	5
(Number of respondents)	(79)

Table 5.17 **Accountants on the Entrepreneurial Spirit**
Do you believe the entrepreneurial spirit in America in recent years has:

	%
Been strengthened	29
Declined	42
Stayed the same	28
Don't know	1
(Number of respondents)	(79)

Table 5.18 **Accountants on the Ways to Stimulate The Entrepreneurial Spirit**
Which of the following would be the *one or two best ways* to stimulate the entrepreneurial spirit?

	%
Easier financing for new businesses	52
Easier access to equity capital in public and private markets	29
Incentives, such as tax credits	28
More business skills taught in the public schools	22
Reduce government regulation	15
Changes in society's attitudes toward business people	6
(Number of respondents)	(79)

Accountants on Local Issues Affecting Small Business

The accountants who serve small businesses in the New York metropolitan area substantially agree with the entrepreneurs in the area about which issues need immediate attention. The three issues mentioned most frequently by both surveyed groups are crime, the cost of commercial space, and traffic congestion and parking. Sixty-three percent (63%) of the accountants also agree that county governments are doing a fair to poor job in fostering a good climate for small business.

Table 5.19 **Accountants on Small Business' Local Concerns**
I am now going to ask you about some issues that might need attention in the smaller businesses' local areas. In your opinion, which need immediate attention and which are manageable problems in these businesses' areas?

	Needs Immediate Attention	Problem Is Manageable	Don't Know/ No Answer
	%	%	%
Cost of commercial space	75	24	1
Crime	67	32	1
Deteriorating neighborhoods	53	43	4
Traffic congestion or parking	53	43	4
Availability of commercial space	49	49	2
Public transportation	48	47	5
Residential housing cost	42	53	5
Neighborhood cleanliness	39	60	1
Lack of local governmant support	39	57	4
Unemployment	38	57	5
Water and air quality	20	76	4
Inflexible zoning ordinances	10	80	10
(Number of respondents)	(79)		

Table 5.20 **Accountants on County Government Performance**
How would you rate the job the county/borough government is doing to foster a good climate for the smaller businesses you deal with?

	%
Excellent	3
Good	20
Fair	48
Poor	15
Don't know	14
(number of respondents)	(79)

Only one-quarter (24%) of the accountants say that small business owners are familiar with municipal or county low-rate industrial bonds. This is consistent with what the entrepreneurs themselves say. In addition, only 27% say small companies are familiar with other programs for low-rate capital financing.

The accountants, however, by a large margin overestimate how interested these entrepreneurs are in industrial development bond programs and how well these programs meet the needs of small companies. Seventy-nine percent (79%) of accountants believe small business owners are interested in these programs, compared with 54% of the entrepreneurs themselves. Likewise, 63% of the accountants say these programs meet the needs of small companies, whereas only one-third (33%) of the business owners say they do.

Table 5.21 **Accountants on Small Business Familiarity with Industrial Development Bonds**
How familiar are the smaller businesses you deal with with municipal or county low-rate industrial development bonds?

	%	
Very familiar	6	24%
Somewhat familiar	18	
Sightly familiar	29	
Not at all familiar	46	
Don't know	1	
(Number of respondents)	(79)	

Table 5.22 **Accountants on Small Business Familiarity with Other Low-Rate Financing**
How familiar are such companies with other programs for low-rate capital financing?

	%	
Very familiar	2	27%
Somewhat familiar	25	
Slightly familiar	41	
Not at all familiar	28	
Don't know	4	
(Number of respondents)	(79)	

Table 5.23 **Accountants on Small Business Interest in Industrial Development Bonds**
How interested would you say these businesses are in industrial development bond programs which provide low-interest financing for capital expansion?

	%	
Very interested	32	79%
Somewhat interested	47	
A little interested	16	
Not at all interested	5	
(Number of respondents)	(79)	

Table 5.24 **Accountants on Usefulness of Industrial Development Bonds**
How well do such bond programs meet the needs of these smaller companies?

	%	
Very well	21	63%
Somewhat well	42	
Not very well	32	
Not at all	5	
(Number of respondents)	(79)	

Observation

While government agencies and financial institutions could be doing more to meet the financing needs of small businesses, many of the programs currently in place are poorly understood by or unknown to small business owners. Accountants, who typically demonstrate an excellent understanding of small business issues, give the industrial revenue bond program high marks for meeting small business needs, and suggest that many small business owners would be interested. These findings, combined with earlier results showing that accountants feel they can do more to help their clients with financing, suggest that accountants, along with banks, may be of considerable assistance in alerting clients to currently available sources of low-cost financing.

SMALL BUSINESS SPEAKS

Appendix I

The New York Metropolitan Area Small Business Owners:

A Profile

The Survey Respondents

The typical New York metropolitan area small business owner is a white male, between 51 and 65 years of age, and a college graduate. His annual household income is between $60,000 and $75,000.

The typical small business has existed for between thirty and thirty-nine years and has annual sales between $1 and $2.9 million. The company employs between eleven and twenty people.

The Companies

The founding dates of small businesses in the New York metropolitan area reveal a continuing pattern of growth with a particular increase in business starts after World War II. About four in ten of the small businesses studied were started between 1944 and 1963. About one in ten were established in each of the preceding and following decades.

Table A

Year Business Was Founded
In what year was your firm started?

	%
Before 1914	10
1914-1923	6
1924-1933	12
1934-1943	12
1944-1953	22
1954-1963	19
1964-1973	10
1974-1983	9
(Number of respondents)	(1047)

About four in ten (38%) companies qualifying for the survey have less than $1 million in annual sales. Another 46% have annual sales of $1 to $2.9 million. Only about one in seven (16%) have annual sales between $3 and $5 million.

Table B

Annual Sales
What is the total annual sales of your company?

	%
$500,000-$999,000	38
$1 to 2.9 million	46
$3 to $5 million	16
(Number of respondents)	(1047)

Three-quarters of all small businesses (73%) currently employ twenty or fewer full-time employees, and 43% employ fewer than ten people. Only 5% of the firms employ more than ten part-time employees.

Table C **Number of Employees**
How many people does your firm currently employ?

	Full-time Employees	Part-time Employees
	%	%
Fewer than 10	43	95
11-20	30	3
21-30	12	1
31-40	6	0
40 and over	10	1
(Number of respondents)	(1047)	(1047)

International Businesses

Four in ten (41%) of the small businesses in the New York metropolitan area are doing at least some exporting and importing of goods and services. Manufacturing, communications, wholesale and retail companies are doing more international business than are the other industry categories.

Similar percentages say they would like to increase their international activities in the 1980s (46%) and say that it is likely they will in fact increase their importing and/ or exporting over the next few years (41%). Manufacturing, communications and wholesale firms are the most likely to say they foresee increasing their importing and/or exporting.

Table D **Import/Export by Industry Type**
Over the last twelve months has your business imported or exported any goods or services?

	All Respondents	Manufacturing	Wholesale	Retail	Services	Construction	Communications	Finance
	%	%	%	%	%	%	%	%
Imported	14	14	21	12	5	4	0	0
Exported	12	14	16	2	11	6	26	17
Imported and exported	15	17	23	1	17	3	20	0
Other	56	54	38	81	68	82	40	74
Don't know/ No answer	2	1	2	3	0	4	14	9
(Number of respondents)	(1047)	(439)	(250)	(167)	(56)	(52)	(34)	(15)

SMALL BUSINESS SPEAKS

Table E

Desire to Increase Import/Export Trade
Would you like to expand your international activities in the 1980s?

	%	
Very much	27	46%
Somewhat	19	
Not really	49	
Don't know/No answer	5	
(Number of respondents)	(1047)	

Table F

Likelihood of Increasing Import/Export Trade by Industry Type
How likely is it that your company will increase importing and/or exporting over the next few years?

	All Respondents	Manufacturing	Wholesale	Retail	Services	Construction	Communications	Finance
	%	%	%	%	%	%	%	%
Very likely	22	24	34	8	16	5	28	6
Somewhat likely	19	24	18	11	9	6	13	17
Not very likely	12	13	13	6	13	5	7	0
Not likely at all	41	33	31	67	59	77	37	67
Dont know/ No answer	7	5	5	9	4	8	15	10
(Number of respondents)	(1047)	(411)	(245)	(178)	(61)	(57)	(38)	(23)

SMALL BUSINESS SPEAKS

The Computer Revolution

Computers have begun to make an impact on small businesses—about a quarter or more are using computers—and more than half of the business people who do not currently have computers foresee having one in their home or business in the near future.

Twenty-five percent (25%) say they are currently using computers for financial management. About one in six (17%) are using computers in manufacturing and operations, and another one in ten (9%) are using them in staffing and personnel areas. Of those who have computers, a large majority (84%) say that computerization has been a significant benefit to them.

Of the small business leaders who do not currently have a computer, about one-third (34%) expect to have one at work in the near future, and another 15% say they expect to have computers both at home *and* at work.

Table G **Computerization**

Have you computerized your business operations in any of the following areas?

	Yes	No	Don't Know/ No Answer
	%	%	%
Financial management	25	74	1
Manufacturing and operations	17	81	2
Staffing or personnel	9	89	2
Other	8	29	63
(Number of respondents)	(1047)		

Table H **Benefit of Computerization**

Have you found computerization to be a significant benefit?

	%
Yes	84
No	16
(Number of respondents)	(377)

Table I **Future Computerization**

Do you intend to have a computer in the near future in your home or business?

	%
Already have one in home or business	2
Yes, at home and work	15
Yes, at home only	4
Yes, at home only	34
No	40
Don't know/No answer	4
(Number of respondents)	(1047)

The Owners

The overwhelming majority (93%) of the heads of small businesses are men. Only 16% are under the age of 35; 30% are between the ages of 35 and 50, and 41% are 51 to 65 years old. Eighteen percent (18%) describe their business as "minority-owned." Eighty-five percent (85%) of these business leaders are married. About three in ten (27%) say their spouses are employed inside their firm, and another 25% say their spouses are employed outside their firm.

More than half of the business leaders have at least a college education. Forty-one percent (41%) are college graduates, and another 12% have either an MBA (6%) or another graduate degree (6%). Their median total annual household income falls in the $60,000 to $75,000 range. Only 3% have household incomes of less than $25,000, while about one in ten (11%) have household incomes of more than $100,000. These business people's incomes are substantially higher than the national median family income ($19,917, according to the 1980 census) and higher than the New York City ($18,268) and New York state ($20,180) median family incomes.

Table J **Gender**

	%
Male	93
Female	7
(Number of respondents)	(1047)

Table K **Age**

Under 35	16
35 to 50 years old	30
51 to 65 years old	41
Over 65 years old	11
Don't know/No answer	2
(Number of respondents)	(1047)

Table L **Minority-owned Businesses**
Is yours a minority-owned business?

	%
Yes	18
No	78
Don't know/No answer	4
(Number of respondents)	(1047)

Table M **Marital Status**

	%
Married	85
Single	9
Other	5
Don't know/No answer	1
(Number of respondents)	(1047)

Table N **Spouses Employed in the Business**
Does your spouse work in your business at all?

	%
Yes	27
No	73
(Number of respondents)	(1047)

Table O **Spouses Employed Outside the Business**
Is your spouse employed *outside* your firm?

	%	
Full-time	18	25%
Part-time	7	
No	64	
Don't know/No answer	11	
(Number of respondents)	(1047)	

Table P **Education**
What is your educational level?

	%
Some high school	4
High school graduate	17
Some college	22
College graduate	41
Post graduate (non-business)	6
MBA	6
Other	2
Don't know/No answer	2
(Number of respondents)	(1047)

Table Q **Annual Household Income**
What is your total annual household income before taxes?

	%
Under $25,000	3
$25,000-$39,999	17
$40,000-$59,999	27
$60,000-$74,999	13
$75,000-$100,000	14
Over $100,000	11
Don't know/No answer	16
(Number of respondents)	(1047)

SMALL BUSINESS SPEAKS

Appendix II

Methodology

A three-phase research design was used in conducting this study of New York metropolitan area small businesses and business people.

Phase One

The first phase consisted of qualitative and background research undertaken to generate hypotheses and develop topic areas for the survey of business people. This process included discussions with New York metropolitan area journalists concerning their perspectives on what are the issues of greatest concern to owners and managers of smaller businesses.

Phase Two

The second phase of the study was a survey of owners and managers of smaller businesses in the nine-county New York State, New York metropolitan area: (1) New York/Manhattan; (2) The Bronx; (3) Queens; (4) Kings/Brooklyn; (5) Richmond/Staten Island; (6) Westchester; (7) Rockland; (8) Nassau; and (9) Suffolk. "Small businesses" were defined as firms with annual sales ranging between $500,000 and $5 million. The sample was randomly selected from lists of firms with those sales figures provided by Dun & Bradstreet. A screener question at the beginning of the interview confirmed the qualifying sales figure for each company.

To qualify for the survey, respondents also had to be the owner, president, partner, or principal stockholder of the company.

Thirty trained interviewers conducted the telephone interviews between 10:00 a.m. and 5:00 p.m., Monday through Friday, from July 5, 1983 through August 15, 1983.

Briefings were held before each daily interviewing session to discuss the data collection process. Interviewers were urged to ask questions at any time throughout the interviewing period. Supervisors audited each interviewer periodically in order to ensure accuracy and to prevent bias.

In order to ensure that the respondents represented a random sample of the area business people within the sales-figure criterion, at least four call-backs were made to each telephone number that had neither yielded a complete interview nor been disqualified. The components of the response rate are listed below.

Table A

Responses to Small Business Survey

Completed Interviews		1047
Non-Response		3907
Call-backs	1788	
Refusals	1921	
Terminations	198	
Excluded from Sample		832
Disconnected	422	
Always busy	108	
Never answered	302	
Total Number of Calls		5786

Weighting. In order to make valid projections to the entire universe, the data from the survey was weighted to reflect the distribution of small businesses throughout the nine counties.

Table B **Weighting**

	Actual Interviews Completed	Percentage of Completions	Dun & Bradstreet Distribution	Weighted Percentages
New York/Manhattan	309	29.5	46.7	47
The Bronx	51	4.8	3.6	4
Queens	114	10.8	8.7	9
Kings/Brooklyn	100	9.5	10.1	10
Richmond/Staten Island	55	5.2	1.2	1
Westchester	109	10.4	7.1	7
Rockland	58	55.3	1.5	2
Nassau	135	12.8	13.2	13
Suffolk	116	11	7.9	8

Phase Three

An additional survey was conducted of accountants in the nine-county area who primarily serve smaller businesses. The sample was randomly selected from accounting firms in the nine-county area listed in the American Institute of Certified Public Accountants' most recent national directory, *Accounting Firms and Practitioners, 1981*. Respondents had to deal mostly with businesses with annual sales between $500,000 and $5 million.

Interviewing procedures were the same as identified for the small business survey as described above and took place between August 4, 1983 and August 12, 1983.

Table C **Responses to Accountants' Survey**

Completed Interviews		79
Non-Response		90
Call-back	26	
Refusals	62	
Terminations	2	
Excluded from Sample		65
Disconnected	8	
Always busy	1	
Never answered	12	
Not qualified	44	
Total Number of Calls		234

Confidence Limits. Data collection techniques ensured that the randomness of the telephone number selection process was maintained. The random selection process is necessary to enable application of probability theory to measure the sampling error for percentages reported in this study.

The normal approximation of the 95% confidence limits for the dichotomized percentage results of the sample may be computed as follows:

$$\text{Sample Confidence Limits} = p \pm \left[1.96 \sqrt{\frac{p(1-p)}{(n-1)}} + \frac{1}{2n} \right]$$

where p is the percentage result divided by 100, and n is the sample size, excluding missing data. A table of the estimated sampling error for binomial percentage at the 95% confidence level is reproduced below.

Table D **Estimated Sampling Error for Binomial Responses**

Sample Size	95% Confidence Level				
	50/50	60/40	70/30	80/20	90/10
100	10.0	9.8	9.2	8.0	6.0
200	7.1	6.9	6.5	5.7	4.2
300	5.8	5.7	5.3	4.6	3.5
400	5.0	4.9	4.6	4.0	3.0
500	4.5	4.4	4.1	3.6	2.7
600	4.1	4.0	3.7	3.3	2.4
700	3.8	3.7	3.5	3.0	2.3
800	3.5	3.5	3.2	2.8	2.1
900	3.3	3.3	3.1	2.7	2.0
1000	3.2	3.1	2.9	2.5	1.9

Statistical Analysis. The bulk of analyses reported in the text are illustrated with cross-tabulation data. Relationships between variables were confirmed by reference to the Chi Square and Pearson's R statistics where possible.

SURVEY ADVISORS

The Honorable Henry Nowak
United States Congressman from New York (33rd District)

Emanuel Tobier, Ph.D.
Professor of Economics
Graduate School of Public Administration
New York University

RESEARCH & FORECASTS STAFF RESPONSIBILE FOR THIS STUDY

Peter Finn, M.A.
Chairman

John Crothers Pollock, Ph.D.
President

Franklin J. Walton, Ph.D.
Project Director

Adam Snyder
Senior Writer

Dena Merriam
Research Analyst

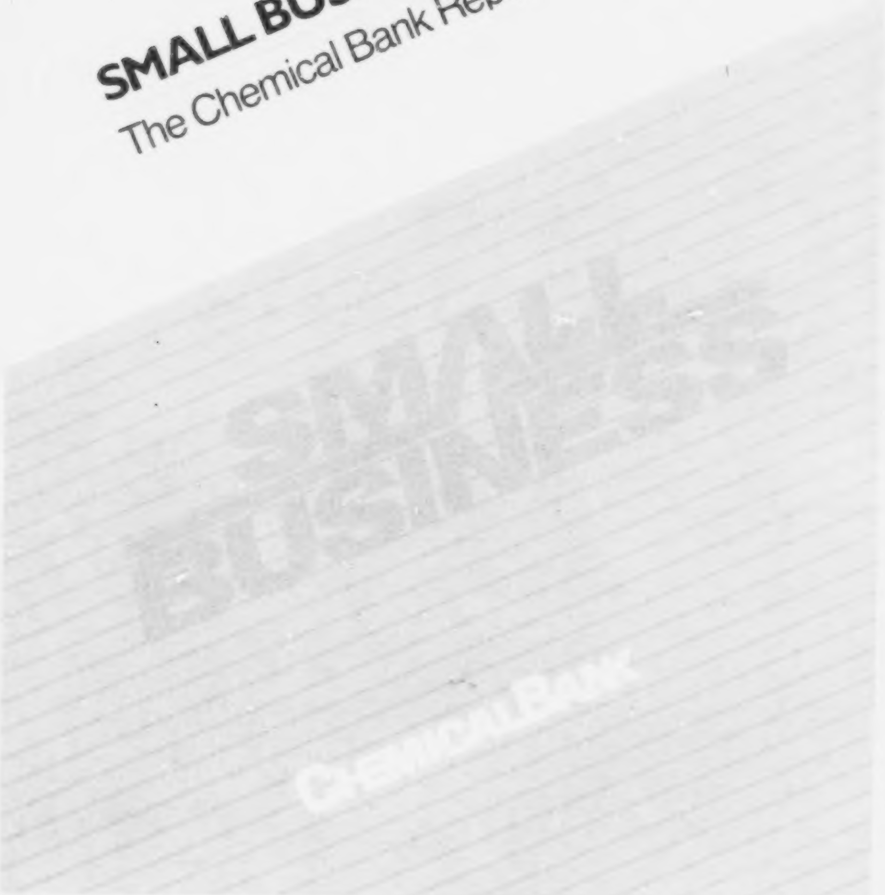
Arthur G. Pfenning
Director of Data Collection

Patricia Cardwell
Field Manager

David Sanua
Production Editor

SMALL BUSINESS SPEAKS

The Chemical Bank Report


SMALL
BUSINESS
CHEMICALBANK

OVERVIEW

SMALL BUSINESS SPEAKS

Overview *Small Business Speaks: The Chemical Bank Report* is the first comprehensive effort to document the professional and personal concerns of small business owners in the New York metropolitan area. Serious studies have investigated the issues that interest mid-sized companies or large corporations, and a wealth of anecdotal material is available on smaller neighborhood stores (below $500,000 in sales). But *The Chemical Bank Report* is the first systematic effort to map the economic and business expectations, as well as lifestyle patterns, of business owners in the uncharted realm between the smallest and the mid-size endeavors: small businesses with sales between $500,000 and $5 million.

Small Business Speaks arrives at some surprising and perplexing conclusions about the metropolitan area's small business owners, among them:

- Despite optimism for their firm's future, only a minority of respondents expect small business to play an increasing role in the American economy.
- Despite confidence in their own ability to learn from the recession and succeed, only a minority believe small business can make a significant contribution to the country's economic growth.
- Despite personal financial success, respondents record noteworthy levels of stress and its companions, irritability and medical problems.
- Juxtaposed with assertions that starting or owning one's own business is well worth all the sacrifices, and the fact that almost all those surveyed would do it again, few respondents wish their own children to enter their own businesses.
- Despite the availability of government, banking and educational programs designed to help entrepreneurs, strikingly few respondents believe government at any level, banks, or public education systems have helped small business owners very much at all.

Small business owners appear to have found comfortable answers to these puzzles and paradoxes primarily because they have developed an extraordinary capacity to focus on critical essentials: business and family. They devote vast numbers of hours to each, often combining the two. Although they are concerned about the national economic outlook, and although they believe governments, banks and the educational system have failed to offer substantive support, small business owners are nonetheless overwhelmingly self-confident about the lessons their own firms have learned from the recession, resilient and optimistic about personal chances for success. What emerges so clearly from this survey of the way small business owners balance business and personal concerns is that they see themselves essentially as model rugged individuals, buffeted by chance and circumstance, but successful upstream swimmers.

OVERVIEW

This vibrant self-confidence emerges in every section of the investigation and is immediately clarified by posing a sequence of commonsense questions:

- How do small business entrepreneurs view their role in local, metropolitan, and national economies?
- How do small business owners balance the complex task of fulfilling responsibilities to both occupation and family?
- What neighborhood and municipal support problems do small entrepreneurs identify and how do they respond?
- How do small business executives evaluate the private sector support system of banks and trade associations?
- What are their future goals for their businesses and their offspring?

The answers to these questions illuminate the resolution and commanding determination of seldom-noticed owners of small business in the face of adversity. This personal, straightforward, no-nonsense approach to business and personal life contrasts sharply with their view of business prospects nationally and is illustrated well in responses to two questions. When asked whether the entrepreneurial spirit in America had declined in recent years, a plurality of 41% replied that it had indeed declined, while 29% said it had stayed the same, and only one-quarter believed that spirit had been strengthened. When asked what might stimulate the entrepreneurial spirit best, pluralities of 38% and 31% chose immediate measures, such as easier financing for new businesses, and incentives, such as tax credits, over teaching more business skills in the public schools.

OVERVIEW

SMALL BUSINESS SPEAKS

Table A **Has the Entrepreneurial Spirit Declined?**
Do you believe the entrepreneurial spirit in America in recent years has:

	%
Been strengthened	26
Declined	41
Stayed the same	29
Don't know/No answer	4
(Number of respondents)	(1047)

Table B **Stimulating the Entrepreneurial Spirit**
Which of the following would be the *one or two best ways* to stimulate the entrepreneurial spirit?

	%
Easier financing for new businesses	38
Incentives, such as tax credits	31
More business skills taught in the public schools	25
Easier access to equity capital in public and private markets	24
Reduce government regulation	19
Changes in society's attitudes toward business people	14
(Number of respondents)	(1047)

Optimism In The Face of Economic Adversity

Though the economy, on a national level, is in the midst of a strong recovery, the recession is not over yet for a substantial number of small businesses in the New York metropolitan area. A 59% majority of executives report feeling a "slight impact" or "no impact at all" when asked about the recovery. Only 22% say they have "definitely" felt the recovery's impact. Similarly, nearly two in three (64%) executives give negative marks to the present economic climate as it affects small business.

Respondents are further convinced that inflation rates and interest rates (of more concern to small entrepreneurs than taxes) will rise in the near future. In addition, many small business owners believe they can't get a fair hearing from local governments, nor that government is fostering a good business climate. Although extremely optimistic about their own business chances, respondents are divided about prospects for small business generally.

OVERVIEW

SMALL BUSINESS SPEAKS

Balancing the Demands of Personal and Professional Life

Owning a small business can be an exacting responsibility, and perhaps one of the reasons respondents are generally optimistic about their own firm's chances is that they are willing to put in long hours and many days per week into occupational tasks. Three out of four (75%) work nine hours or more each day, and more than a third (36%) work eleven or more hours each day. One in three owners also devote more than five days a week to their businesses. This level of personal industriousness raises a classic dilemma for all small business owners: how to balance competing responsibilities to occupation and family?

The personal cost of hard work is clearly high, since about four out of ten (37%) of the sample report a great deal of work-related stress, and another four out of ten (43%) at least a "moderate" amount of stress. The same percentage, 43%, also believe that work-related stress is personally detrimental, while only three out of ten (32%) suggest it has no effect. For those who consider stress detrimental, a large majority (72%) claim it causes them to be irritable, and four out of ten say stress causes health problems and difficulty sleeping.

Surrounded by demands on time and work stress, small entrepreneurs nevertheless make substantial efforts to preserve close family relations. Eighty-five percent (85%) of the respondents are married, and in response to the demands of work, protect time with family by reducing their leisure and vacation activities. But entrepreneurs reveal another effort to protect family ties that is found less often among professionals in other occupations: they employ family and relatives in the firm. More than one-quarter (27%) report a spouse working in the business, over one-third report children in the business, and almost four in ten (38%) say other relatives in the business. In short, respondents not only protect family time; they also integrate family into the work context. It is not surprising that, more than any other source of relief, entrepreneurs cite time with family (64%) and friends (59%), as well as engaging in physical activity (60%), as the ways they most often manage work stress.

The Business Neighborhood

Although small business owners display a low level of satisfaction with the way public institutions have performed their duties, they nevertheless do not make substantial commitments of time and resources for improving their business neighborhoods.

Small businessmen are concerned about a variety of local issues, but their chief concern is crime (55%), follo[illegible] worries about viable commerical space. About one-third of the respondents cite each of the following: cost of commercial space, neighborhood cleanliness, traffic congestion and parking, deteriorating neighborhoods, and lack of local government support. Businessmen are not only worried about these problems. They also do not believe government officials are responsive to such concerns.

Respondents do not generally believe they can get a fair hearing from government officials on any level, nor do they believe their counties are doing a good job of fostering a healthy climate for small businesses. Perhaps this pattern of disillusion with government performance, along with substantial work commitments, help explain low levels of civic involvement among entrepreneurs.

Among the institutions that disappoint respondents, the public education system deserves special attention. Almost three-quarters of the respondents (73%) believe the education system does *not* provide skills and training for business ownership or management. Further, the majority (55%) of entrepreneurs believe on-the-job training or work experience is the *best* preparation for business ownership, compared to a much smaller vote (22%) for college education, and (12%) for a masters degree in business administration. In general, only one-quarter of the sample believe that the best way to stimulate the entrepreneurial spirit in America would be for public schools to teach more business skills. A clear plurality of four out of ten, by contrast, believe the best entrepreneurial stimulus would be to provide easier financing for new businesses, and an additional 24% recommend easier access to equity capital in public and private markets.

Disillusion with public services and official access does not lead to widespread thinking about relocation; most entrepreneurs plan to stay in their own areas. Only 18% of the sample say they are likely to relocate within the next two years. Rather, disappointment with civic resources appears to reinforce the intense individualism already evident in the New York area's successful entrepreneurs. Rather than expect much from public institutions, they want easier access to financing for those ambitious individuals who, like themselves, are willing to labor hard and long enough to make a business prosper.

Banks and Trade Associations: How Helpful Are They?

Consistent with their prevailing "lone eagle" orientation, receiving little assistance from others, small businessmen believe they receive little attention from banks. About two-thirds of the respondents (65%) believe banks are more interested in big business than in small business. Although half (52%) say a banker has visited them personally within the last year, only 37% rate banks as good or excellent in providing financial services to small businesses, and 52% believe banks have done only a fair to poor job. Trade associations are considered more helpful, with six out of ten (60%) rating them very or somewhat important, especially regarding: general business information, marketing information, lobbying efforts, and as sources of business contacts.

Curiously, alongside their criticism of access to banking services, small businessmen appear strikingly ill-informed about services that banks, and banks together with local governments, provide. Respondents reveal they are not at all well informed about municipal or county low-rate industrial development bonds, or other programs for low-rate capital financing. This information "gap" between what is available and what entrepreneurs know suggests that banks can play a critical role for small businesses if they make initial efforts simply to keep them informed about low-cost financing opportunities.

Faced with what they consider a lack of general support from the outside, small businessmen rely chiefly on accountants for handling a wide array of business problems, and given their importance, it is also striking to learn that the most frequently cited complaint about banks is the lack of coordination between banks and accountants.

The Future

Consistent with their views on other issues, for entrepreneurs the future is as compartmentalized and tightly focused as their own career histories. Trusting themselves, family, close friends, and accountants, small businessmen demonstrate a remarkable ability to distance themselves from their surroundings.

Despite their pessimism about rising interest and inflation rates, respondents are clearly happy they chose to create their own businesses, and despite lack of regular hours or leisure opportunities, the vast majority of respondents would do it again. Yet, few, only 34%, have made any preparation for the transfer of management or ownership despite median ages in the middle-aged category. Further, what parents expect for themselves and what they wish for the future of the firm and their children are quite different matters. Only 18% wish their children to enter their own businesses, while 30% recommend entering a "profession," and another 22% wish them to start their own business or work for another company.

Many respondents believe their efforts are not directed toward building an enduring enterprise that grows beyond their own lifetime. Their vision of the American dream is not that their children enter their own businesses, but that children enter professions or even other businesses, preferably large ones, unlike their own. Small business owners in the New York metropolitan area view themselves and their businesses as transitional steps in a struggle toward a better life. They are classic Americans, fulfilling the goals of independent achievement through personal struggle. Their enterprises are viewed as useful for one generation of family entrepreneurs, not an inheritance but a resource for individual and family aspirations.

Mr. **Nowak**. Thank you. I was going through the booklet and survey, "Small Business Speaks." I think it contains a lot of very valuable information. I think taking some time to try to analyze the individual answers and how they relate to the total opinion really will give us some insight as to what many of the problems are and the status of small business.

I don't want to take the time of the committee to go through each and every one, but I think you get the same indications from your survey. I think Mr. Wulfing made the statement about 65 percent of those respondents said that they think big business is better served by the banking community out there?

Mr. **Wulfing**. Yes, that was the number. That is certainly their perception. There are ways, we think, however, to change that perception and what Bill Mooney discussed, we believe is having an impact in our area. In fact, the real aggressive interest of other large and small banks in the small business market in New York City will start to change that perception.

Mr. **Mooney**. In the past 2 weeks, as a matter of fact, we have hosted a group of seminars, specifically designed for small business in the Metropolitan New York area, of which we had over 1,000 participants, and I think there's no question that the perception of small businesses that banks, in general, do not gear themselves toward small business.

As Bill said in his statement, there's a tremendous informational gap here. That's probably part our fault and probably part their fault, and I think that we certainly in the metropolitan region are going to go all out in 1984, 1985, to alleviate that perception.

Mr. **Nowak**. Well, the survey probably confirmed a lot of the thoughts the small business community has and have expressed throughout the report. Based on that I know that you've been active in the small business area, and the small business unit.

I am wondering if you had any changes that you are thinking of instituting in the book's small business unit.

Mr. **Mooney**. I think if anything it has encouraged us to aggressively, to fill the void, if you will, on that informational gap to make the small businessperson more aware of capital access, equity access, low-rate borrowings if you will, and I think it's equally important that one of the problems he's facing in the next few years is a technology gap.

I think that we're going to try and help that void, as well. I think our obligation is not only to handle a transaction of borrowing and liabilities, but our obligation is also to fill the void in some other areas to help make him the full-rounded businessperson that he needs to be to meet the challenge of the 1980's and the 1990's.

We're seriously considering taking on that challenge as well, I might add.

Mr. **Nowak**. We're going through so many vast changes so quickly in this whole information processing area. I had the opportunity to address a business group the other day, and really got the feeling that they're confused because so much information is being thrust upon them. They can't even take the time to try to put it in any order. It's just out there and the computers are spinning off enough information and they don't know how to handle that basic tool yet.

Unless we get that information to them in an organized manner, they're going to be swamped, and if that happens, of course, the small businessman is not going to be able to compete in this whole area. In that regard, the void that you perceive out there, I think, is very real, and I am wondering if you have had the ability to put together a package that you think will respond to their needs or what you think will happen in the future.

Mr. WULFING. We know, Mr. Chairman, that they have historically turned to their trade associations for that sort of guidance, information, business contacts, and contact with committees such as yourselves.

We are in the process of establishing our own contacts with those trade associations to find out how can we further help them in that vital role. We're additionally looking today, in fact, with the New York Board of Trade to determine what sort of roundtable type arrangement might well represent the questions that small business has, the interest that it has and get information back to them on how to take action.

In our area there has not been any sort of galvanizing effect to bring small businesses together to either raise questions or ask for action, so we see a liaison role among both community, trade, small business and banks.

Mr. NOWAK. If total geographic deregulation comes about, do you believe that a program such as you alluded to before, without personal service and so forth, and that your small business program could help maintain, is it set up to solve that problem?

Mr. MOONEY. Yes, understanding Chemical Bank, Chemical Bank obviously is a large banking institution, but we perceive ourselves in the geographical area that we serve as a lot of communities, and we perceive ourselves, I might add, as a community banker.

I personally have worked for a small regional bank for a number of years, and in 1971, I was part of an acquisition involving Chemical Bank. I might add that the personal spirit that Chemical Bank brought not only in the sense of community involvement, but the huge resources that it brought to a local community were absolutely overwhelming in a sense of helping that community.

I think of using yours as a perception that everybody has talked about this morning, that the large bank doesn't have a personality and doesn't understand small business. Well, certainly Chemical Bank personifies the fact that we are helping small business in a big way.

Mr. NOWAK. I think your small business unit is somewhat unique in the industry, too, in that all the banks that have moved do not move with the small business unit already set up. There is the time element. I would suspect that you'd still have to spend the time to get to know the small businessman in that area no matter who was put in charge of the local bank.

Even if you kept the existing loan personnel, there would be changes that you'd be able to bring to bear and perhaps if you had the package already instituted in the bank. Is what you're saying that it would be made available to the community that you're moving into?

Mr. WULFING. Absolutely. I think we believe so strongly in the concept of the business action unit that wherever we operate, and it is throughout New York State, where there are concentrations of small businesses that need this type of credit as they all do, need a guaranteed turnaround on deals. You yourself referred earlier to the fact that opportunities are lost because credit requests take 4 or 5 or 6 or 8 weeks to get a response to.

We guarantee through these groups a 72-hour initial response on a credit, and we will close the deal within the shortest period of time possible, but we'll get back to the applicant within 72 hours to give a very, very strong indication of how we would approach it, and whether or not that suits his needs so that he's not left hanging, waiting for the answer.

Mr. **Nowak**. Mr. Williams.

Mr. **Williams**. Has deregulation increased the pool of money to small business, in your opinion?

Mr. **Mooney**. I think it certainly has enabled us, if you will, to supply more money to the small businessperson. I think the verdict is still out whether it has increased his cost or increased our cost at this point in time.

I personally do not see any increased cost at this time. I am not talking about absolute interest rates. I am talking about spreads.

Mr. **Nowak**. As we go into 1986 to carry out the deregulation to affect the so-called savings book deposit account, and the $5.25 that are existing. In looking at some figures that were supplied which measures the money, stock for commercial savings and loans and securities savings deposits have gone from some $420 billion in December 1979 to $326 billion in July 1983, which is a decrease of 22.47, two other accounts primarily of some higher bearing rate.

If this has changed, you're going to have that moving up, I would assume to, somewhere near or at the other rates that are existing for 2 months or 6 months or whatever. That mixes, as I see it, about one-eighth of the dollars that are deposited or were deposited in July of this year so you're going to have that kind of an impact to raise the cost of dollars or that commodity to the banks.

If we're looking at two or three points, the question is, is that going to be a factor that is going to tend to keep rates at least at the levels of 2 or 3 points above whatever your average is at that point in time? I know that we can't say that it's going to be exactly 9½ percent, but it's certainly going to be higher than 5¼ percent.

Mr. **Wulfing**. We are obviously concerned about that subject, and you would think as we pointed out earlier that there are certainly some effect, and if we're paying more for our funds, then if there were a migration from 5¼ percent accounts to higher accounts, that that cost must be passed on in one way or the other, and it must.

As some of our economists have said, and as we've practiced, and we think other banks are also, we're trying to recover those costs through other ways as well, not just through loan rates, but through analyzing what the cost of running that deposit account is and charging fees that are appropriate to cover that cost. We relate the deposit costs to the deposit income rather than the deposit cost only to loan rate.

Additionally, I mean there is a penalty paid. Since our cost of funds is so much higher, what else do we do. Well, one thing to look at is our massive branch structure. Will we always be able to support that branch structure which was viewed as a deposit gathering source?

We have to change the way we deliver services to the whole community in order to continue to deliver on our principal asset function, which is lending.

There are certainly pluses and minuses but Bill and I think of ourselves not as the economists who can answer that question, but as hopefully the small business experts who can deliver the service regardless of what the rate may be.

Mr. **Mooney**. I think we also found an institutional level. What we're trying to say is that we're not just going to sit back and every time there's an increase in cost, pass it on to the small business guy.

I think what were trying to say is that we're going to look for different ways to do business, some more creative ways and maybe change our delivery system to make it a little more efficient, the delivery services to the small business person.

Mr. **Williams**. Is that flexibility you're talking about in your statement?

Mr. **Mooney**. Pardon me?

Mr. **Williams**. Your flexibility in structuring loans? That is what you're talking about?

You can't give firm examples as to what that might be or can you?

Mr. **Mooney**. Not an absolute example, but I think what we have found as we trained more and more of our people to concentrate exclusively on small business with no diversion of attention to how to make a car loan to a consumer or how to approach IBM. Those people, the expertise of those people and the confidence that they had in determining on how to best work with the small business environment allowed them to be more flexible in making loans, simply through the fact that they knew more about the industry they were lending to, about small business—perhaps needs longer to pay back, perhaps its cash flow has to be looked at more closely, finding the right way to get it done.

Mr. **Williams**. Thank you very much.

Mr. **Nowak**. Once again, let me thank you for the report. I think as we have the opportunity to examine the individual kinds of questions that have been answered here and try to put them together totally, we're going to see the need perhaps for other institutions both large and small to try to fit together some type of expanded servicing other than a rate structure for small business, and the model and the experience that Chemical has had in this area, I think, is going to be very helpful as a guide.

It just seems to me that the need for these types of organizations are growing dramatically because of the complexities that everybody is involved with, from the rate to the reliability to, I guess, what kind of computer can fit into the structure of the business and the bank and the customers that he's serving. All of these things are going to require much more sophistication and I think probably was needed to run a successful business 10 or 15 or 20 years ago. The trade associations, as you say, are probably trying to help in this area. I think the interconnection between all of these things is going to prove very valuable, and we'll look forward to seeing the results of this and any further information that you feel is helpful. The subcommittee would appreciate receiving a report of results you obtain at different stages of your expansion.

Mr. **Mooney**. I'll be happy to pass those on.

Mr. **Nowak**. And we want to thank you once again for coming and preparing the "Small Business Speaks" report from Chemical Bank, and we'll again just keep the record open in case we have further questions.

Thank you very much.

Mr. **Wulfing**. Thank you.

Mr. **Mooney**. Thank you.

Mr. **Nowak**. Our last witness this morning is the U.S. League of Savings Associations, represented by Howard T. Glover, president of Conneaut Savings & Loan Co. Mr. Glover has been in savings institutions for the past 24 years. He is particularly active in the small business community, and serves as a member of the National Advisory Council to the SBA. He is also chairman of the U.S. league's committee for the development of smaller institutions, and we want to welcome Mr. Glover before the committee.

TESTIMONY OF HOWARD T. GLOVER, PRESIDENT, CONNEAUT SAVINGS & LOAN CO.

Mr. **Glover**. Thank you, Mr. Chairman, for the opportunity to appear before you again. We know you are particularly concerned today with our Nation's housing finance and housing construction sectors, sectors heavily populated by members of the small business community.

Your inquiry comes at a fortunate time in that the U.S. league is in the process of a major study of homeownership opportunities in the 1980's.

Our homeownership task force has been uncovering problems which are of deep concern. For example, the percentage of homeownership is declining. Beginning in the 1940's home ownership in this country maintained a steady growth pattern. That continued until the start of this decade.

Thus far in the 1980's, homeownership has declined by nearly 1 full percentage point to 64.8 percent. We also have an affordability gap. By that I mean the cost of available housing is far beyond the price a would-be homeowner can realistically pay.

Our study shows this gap to be about $14,000. Furthermore our studies have uncovered a developing demographic quirk. There are more borrowers than savers today as a result of our population makeup.

We see the number of Americans in the 25- to 44-year age bracket increasing. These are the prime borrowing years when money is needed for housing, children's education, and so on.

At the very same time, the number of Americans in the 44- to 65-year age bracket is proportionately declining. This is the period in life when most people save heavily. The result of this phenomenon is that the pool of savings needed to finance housing is declining at a time when we badly need more and not less in the capital pool to meet rising housing demands.

At the same time, we see budget deficits of enormous proportions, Federal budget deficits which placed an additional drain on the availability of loanable funds. I have attached to my statement copies of the two interim reports, which the U.S. league's homeownership task force has produced to date, and I would ask that they be made a part of this hearing record. These reports point up serious problems facing the Nation's housing sector in the years to come, and are worthy of study by all Members of Congress.

As to the state of our institution, thanks mainly to two fairly recent occurrences, the condition of savings institutions has improved somewhat in recent months. I refer to the decline in interest rates which began in late summer of 1982 and the enactment in October 1982 of the Garn-St Germain Depository Institutions Act. You will recall that we reached the depths of the 1980–82 economic crisis in January 1982 when an estimated 90 percent of savings institutions were operating in the red.

At present we are experiencing a degree of recovery although we remain wary of the return of double digit market interest rates. Should 6-month Treasury bill rates return to the 10 to 11 percent range, our prospect for full recovery would evaporate rapidly.

Just yesterday, the Federal Home Loan Bank Board announced that the majority of federally insured savings institutions returned to profitability during the first half of this year for the first time since the second half of 1980.

Despite this, 38 percent of all institutions insured by the Federal Savings and Loan Insurance Corporation remained in the red during that same period the bank board reported.

In other words, there was good news and there was bad news, and the bank board's announcement carried with it this cautionary note, and I quote:

> Because of an increase in market interest rates which began this spring, the industry cost to funds has since increased by one-quarter of a percentage point. As a consequence and as a barometer of the fragility of the thrift recovery, the industry has been less profitable in the third quarter than it was in the first half of 1983, according to the preliminary data. This demonstrates the vulnerability of the industry to upward interest rate movements.

In addition to interest rate uncertainty, savings institution managers now find themselves with virtually all of their deposit base deregulated, whereas as recently as 2 years ago virtually all retail deposit accounts carried interest rate ceilings.

Today ceilings exist only on passbook accounts, which make up less than 15 percent of our deposit base, and on NOW accounts. It should be noted that whereas in 1980 the Depository Institutions Deregulation Act ordered a phaseout of rate ceilings by March 31, 1986, that phaseout for time deposits purposes was completed on October 1 of this year.

This has meant that savings institution managers have had to move rapidly to modernize their investment portfolios, and this has been facilitated with the introduction of the adjustable mortgage loan instrument as well as with a limited degree of new investment opportunities provided in the Garn-St Germain Act of 1982.

I emphasize the word limited because while we are not permitted to make commercial real estate, consumer, and general commercial loans, by no means are we permitted to make them on the same scale available to commercial banks.

At this moment our single greatest handicap is dealing with our legacy of low-yielding, long-term fixed rate mortgages. These 25- and 30-year loans were entered into at rates of 7, 8, and 9 percent in conformity with Government regulations which prevailed at that time. While these low-yielding loans remain on our books, the rates we are permitted to pay retail depositors are virtually without ceiling, and depositors fully expect, as they should, to earn market rates on their money.

We are appealing this pressure of consumer expectation at a time when 55 percent of the mortgages on our books are earning less than 10 percent and when 30 percent are under 9 percent.

Many of these loans have 20 to 25 years to maturity, and although you no doubt have read that our institutions have set volume mortgage lending records in recent months, no more than 20 percent of our portfolios earn more than 12½ percent.

Our institutions today report an overall portfolio yield of 10.6 percent while our cost of money is near 10 percent. Admittedly this is a vast improvement over 1 year ago when we were experiencing a negative spread of 1 percent, but the current spread of less than a positive 1 percent is not enough to promote effective competition or to assist in the rebuilding of net worth.

Historically our institutions have required a spread of 1¾ percent for successful operations. The Garn-St Germain Act accomplished the deregulation of time deposits, but more deregulation is necessary on the liability side of the ledger.

I refer specifically to our ability to offer demand deposit accounts, something which would help us to serve better the small business community.

We are particularly encouraged, Mr. Chairman, by the introduction by House Banking Committee Chairman St Germain of H.R. 3535, which for the first time would permit savings institutions to make checking or demand deposit accounts available to all who would seek them.

For too long demand accounts have been the protected and virtually exclusive reserve of commercial banks. Federally chartered savings institutions have been denied the opportunity to service the full spectrum of demand depositors.

Yes, we did receive authorization to offer some demand accounts under terms of the Garn-St Germain Act, but this authority was restricted to those commercial corporate and agricultural customers with whom we had established a loan relationship. Because of this limitation we are unduly restricted from servicing local businessmen, businesswomen, and farmers. It prevents us from offering complete financial services to those involved in the real estate finance and home purchase: family, realtors, builders, local suppliers, contractors, and subcontractors, who have an obvious interest in maintaining an ongoing deposit relationship with our institutions.

Another feature of H.R. 3535 is that it would repeal the half-century-old prohibition on payment of interest on demand deposits which has led to a pattern of banking practices designed to circumvent the restriction.

Commercial banks offer various processing and transfer services to their large commercial customers in order to compensate for their inability to pay explicit interest on the demand deposits.

These benefits to large commercial depositors are not necessarily available to smaller businesses, partnerships, and corporations. Would it be not far more equitable to permit the payment of explicit interest on demand deposits?

We believe that it would be, and, therefore, support passages of H.R. 3535. No doubt you are aware of various efforts toward a major rewriting of the commercial banking and savings and loan holding company laws.

It would appear that the principal focus at this point is on H.R. 3537 and S. 1609, known as the Financial Institutions Deregulation Act which was introduced at the request of the Treasury Department. The outlook for this legislation is rather murky today, and because of this uncertainty, I am not in a position to comment on specifics; however, I would like to address generally a few of the structural deregulation targets, which advocates of these measures have advanced.

This legislation would weaken our service corporation powers substantially, our holding company authorities would be curbed and control of any new activities would be taken away from the Federal Home Loan Bank Board and be given to the Federal Reserve Board.

Over the past half century our savings institutions have provided a reliable flow of housing finance to this Nation's economy, and our Federal Home Loan Bank System has worked well, and there's no greater evidence of that than the fact that it was that system that helped our institutions survive the destructive years of 1980 through 1982.

It is our desire that the Federal Home Loan Bank System be preserved, that the powers under which we presently operate not be diminished, and that our specialty financial institution status remain separate from the commercial banking sector.

Thank you, Mr. Chairman, for your invitation to appear today, and I look forward to any questions you may have.

[Mr. Glover's prepared statement with attachments follows:]

Prepared Statement of Howard T. Glover, President, Conneaut Savings and Loan Company

THANK YOU, MR. CHAIRMAN. YOU ARE PARTICULARLY CONCERNED TODAY, I KNOW, WITH OUR NATION'S HOUSING FINANCE AND HOUSING CONSTRUCTION SECTORS -- SECTORS HEAVILY POPULATED BY MEMBERS OF THE SMALL BUSINESS COMMUNITY.

YOUR INQUIRY COMES AT A FORTUNATE TIME, IN THAT THE U.S. LEAGUE IS IN THE PROCESS OF A MAJOR STUDY OF HOMEOWNERSHIP OPPORTUNITIES IN THE 1980S.

OUR HOMEOWNERSHIP TASK FORCE HAS BEEN UNCOVERING PROBLEMS WHICH ARE OF DEEP CONCERN.

FOR EXAMPLE, THE PERCENTAGE OF HOME OWNERSHIP IS DECLINING. BEGINNING IN THE 1940S, HOME OWNERSHIP IN THIS COUNTRY MAINTAINED A STEADY GROWTH PATTERN. THAT CONTINUED UNTIL THE START OF THIS DECADE. THUS FAR IN THE 1980S, HOME OWNERSHIP HAS DECLINED BY NEARLY ONE FULL PERCENTAGE POINT TO 64.8%.

WE ALSO HAVE AN AFFORDABILITY GAP. BY THAT I MEAN THAT THE COST OF AVAILABLE HOUSING IS FAR BEYOND THE PRICE A WOULD-BE HOME-OWNER CAN REALISTICALLY PAY. OUR STUDIES SHOW THIS GAP TO BE $14,000.

FURTHERMORE, OUR STUDIES HAVE UNCOVERED A DEVELOPING DEMOGRAPHIC QUIRK. THERE ARE MORE BORROWERS THAN SAVERS TODAY AS A RESULT OF OUR POPULATION MAKEUP. WE SEE THE NUMBER OF AMERICANS IN THE 25- TO 44-YEAR AGE BRACKET INCREASING. THESE ARE THE PRIME BORROWING YEARS WHEN MONEY IS NEEDED FOR HOUSING, CHILDREN'S EDUCATION, AND SO ON. AT THE VERY SAME TIME, THE NUMBER OF AMERICANS IN THE 44- TO 65-YEAR AGE BRACKET IS PROPORTIONATELY DECLINING. AND THIS IS THE PERIOD IN LIFE WHEN MOST PEOPLE SAVE HEAVILY. THE RESULT OF THIS PHENOMENON IS

THAT THE POOL OF SAVINGS NEEDED TO FINANCE HOUSING IS DECLINING AT A TIME WHEN WE BADLY NEED MORE -- NOT LESS -- IN THE CAPITAL POOL TO MEET RISING HOUSING DEMAND.

AT THE SAME TIME WE SEE BUDGET DEFICITS OF ENORMOUS PROPORTIONS, FEDERAL BUDGET DEFICITS WHICH PLACE AN ADDITIONAL DRAIN ON THE AVAILABILITY OF LOANABLE FUNDS.

I HAVE ATTACHED TO MY STATEMENT COPIES OF THE TWO INTERIM REPORTS WHICH THE U.S. LEAGUE'S HOMEOWNERSHIP TASK FORCE HAS PRODUCED TO DATE, AND I WOULD ASK THAT THEY BE MADE A PART OF THIS HEARING RECORD. THESE REPORTS POINT UP SERIOUS PROBLEMS FACING THE NATION'S HOUSING SECTOR IN THE YEARS TO COME, AND ARE WORTHY OF STUDY BY ALL MEMBERS OF CONGRESS.

AS TO THE STATE OF OUR INSTITUTIONS, THANKS MAINLY TO TWO FAIRLY RECENT OCCURRENCES, THE CONDITION OF SAVINGS INSTITUTIONS HAS IMPROVED SOMEWHAT IN RECENT MONTHS. I REFER TO THE DECLINE IN INTEREST RATES WHICH BEGAN IN LATE SUMMER, 1982, AND THE ENACTMENT IN OCTOBER 1982 OF THE GARN-ST GERMAIN DEPOSITORY INSTITUTIONS ACT.

YOU WILL RECALL THAT WE REACHED THE DEPTHS OF THE 1980-82 ECONOMIC CRISIS IN JANUARY OF 1982, WHEN AN ESTIMATED 90% OF SAVINGS INSTITUTIONS WERE OPERATING IN THE RED. AT PRESENT WE ARE EXPERIENCING A DEGREE OF RECOVERY, ALTHOUGH WE REMAIN WARY OF THE RETURN OF DOUBLE-DIGIT MARKET INTEREST RATES. SHOULD SIX-MONTH TREASURY BILL RATES RETURN TO THE 10%-TO-11% RANGE, OUR PROSPECTS FOR FULL RECOVERY WOULD EVAPORATE RAPIDLY.

JUST YESTERDAY THE FEDERAL HOME LOAN BANK BOARD ANNOUNCED THAT THE MAJORITY OF FEDERALLY-INSURED SAVINGS INSTITUTIONS

RETURNED TO PROFITABILITY DURING THE FIRST HALF OF THIS YEAR FOR THE FIRST TIME SINCE THE SECOND HALF OF 1980. DESPITE THIS, 38% OF ALL INSTITUTIONS INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION REMAINED IN THE RED DURING THAT SAME PERIOD, THE BANK BOARD REPORTED. IN OTHER WORDS, THERE WAS GOOD NEWS AND THERE WAS BAD NEWS, AND THE BANK BOARD'S ANNOUNCEMENT CARRIED WITH IT THIS CAUTIONARY NOTE, AND I QUOTE:

> "BECAUSE OF AN INCREASE IN MARKET INTEREST RATES WHICH BEGAN THIS SPRING, THE INDUSTRY COST OF FUNDS HAS SINCE INCREASED BY ONE-QUARTER OF A PERCENTAGE POINT. AS A CONSEQUENCE AND AS A BAROMETER OF THE FRAGILITY OF THE THRIFT RECOVERY, THE INDUSTRY HAS BEEN LESS PROFITABLE IN THE THIRD QUARTER THAN IT WAS IN THE FIRST HALF OF 1983, ACCORDING TO PRELIMINARY DATA. THIS DEMONSTRATES THE VULNERABILITY OF THE INDUSTRY TO UPWARD INTEREST RATE MOVEMENTS." END QUOTE.

IN ADDITION TO INTEREST RATE UNCERTAINTY, SAVINGS INSTITUTION MANAGERS NOW FIND THEMSELVES WITH VIRTUALLY ALL OF THEIR DEPOSIT BASE DEREGULATED. WHEREAS AS RECENTLY AS TWO YEARS AGO VIRTUALLY ALL RETAIL DEPOSIT ACCOUNTS CARRIED INTEREST RATE CEILINGS, TODAY CEILINGS EXIST ONLY ON PASSBOOK ACCOUNTS, WHICH MAKE UP LESS THAN 15% OF OUR DEPOSIT BASE, AND ON NOW ACCOUNTS. IT SHOULD BE NOTED THAT, WHEREAS THE 1980 DEPOSITORY INSTITUTIONS DEREGULATION ACT ORDERED A PHASE-OUT OF RATE CEILINGS BY MARCH 31, 1986, THAT PHASE-OUT FOR TIME DEPOSITS PURPOSES WAS COMPLETED ON OCTOBER 1 OF THIS YEAR.

THIS HAS MEANT THAT SAVINGS INSTITUTIONS MANAGERS HAVE HAD TO MOVE RAPIDLY TO MODERNIZE THEIR INVESTMENT PORTFOLIOS, AND THIS HAS BEEN FACILITATED WITH THE INTRODUCTION OF THE ADJUSTABLE MORTGAGE LOAN INSTRUMENT, AS WELL AS WITH A LIMITED DEGREE OF NEW INVESTMENT OPPORTUNITIES PROVIDED IN THE GARN-ST GERMAIN ACT OF 1982. I EMPHASIZE THE WORD LIMITED, BECAUSE WHILE WE NOW ARE PERMITTED TO MAKE COMMERCIAL REAL ESTATE, CONSUMER AND GENERAL COMMERCIAL LOANS, BY NO MEANS ARE WE PERMITTED TO MAKE THEM ON THE SAME SCALE AVAILABLE TO COMMERCIAL BANKS.

AT THIS MOMENT OUR SINGLE GREATEST HANDICAP IS DEALING WITH OUR LEGACY OF LOW-YIELDING, LONG-TERM, FIXED-RATE MORTGAGES. THESE 25- AND 30-YEAR LOANS WERE ENTERED INTO AT RATES OF 7% AND 8% AND 9% IN CONFORMITY WITH GOVERNMENT REGULATIONS WHICH PREVAILED AT THAT TIME.

WHILE THESE LOW-YIELDING LOANS REMAIN ON OUR BOOKS, THE RATES WE ARE PERMITTED TO PAY RETAIL DEPOSITORS ARE VIRTUALLY WITHOUT CEILING, AND DEPOSITORS FULLY EXPECT, AS THEY SHOULD, TO EARN MARKET RATES ON THEIR MONEY. WE ARE FEELING THIS PRESSURE OF CONSUMER EXPECTATION AT A TIME WHEN 55% OF THE MORTGAGES ON OUR BOOKS ARE EARNING LESS THAN 10%, AND WHEN 30% ARE UNDER 9%. MANY OF THESE LOANS HAVE 20 TO 25 YEARS REMAINING UNTIL MATURITY. AND, ALTHOUGH YOU NO DOUBT HAVE READ THAT OUR INSTITUTIONS HAVE SET VOLUME MORTGAGE LENDING RECORDS IN RECENT MONTHS, NO MORE THAN 20% OF OUR PORTFOLIOS EARN MORE THAN 12.5%.

Our institutions today report an overall portfolio yield of 10.6%, while our cost of money is near 10%. Admittedly, this is a vast improvement over a year ago when we were experiencing a negative spread of 1%. But the current spread of less than a positive 1% is not enough to promote effective competition or to assist in the rebuilding of net worth. Historically, our institutions have required a spread of 1.75% for successful operations.

The Garn-St Germain Act accomplished the deregulation of time deposits, but more deregulation is necessary on the liability side of the ledger. I refer specifically to our ability to offer demand deposit accounts, something which would help us to serve better the small business community.

We are particularly encouraged, Mr. Chairman, by the introduction by House Banking Committee Chairman St Germain of H.R. 3535, which for the first time would permit savings institutions to make checking or demand deposit accounts available to all who would seek them.

For too long demand accounts have been the protected and virtually exclusive reserve of commercial banks. Federally-chartered savings institutions have been denied the opportunity to service the full spectrum of demand depositors. Yes, we did receive authorization to offer some demand accounts under terms of the Garn-St Germain Act. But this authority was restricted to those commercial, corporate and agricultural customers with whom we had an established loan relationship.

BECAUSE OF THIS LIMITATION, WE ARE UNDULY RESTRICTED FROM SERVICING LOCAL BUSINESSMEN, BUSINESSWOMEN AND FARMERS. IT PREVENTS US FROM OFFERING COMPLETE FINANCIAL SERVICES TO THOSE INVOLVED IN THE REAL ESTATE FINANCE AND HOME PURCHASE FAMILY -- REALTORS, BUILDERS, LOCAL SUPPLIERS, CONTRACTORS AND SUBCONTRACTORS -- WHO HAVE AN OBVIOUS INTEREST IN MAINTAINING AN ONGOING DEPOSIT RELATIONSHIP WITH OUR INSTITUTIONS.

ANOTHER FEATURE OF H.R. 3535 IS THAT IT WOULD REPEAL THE HALF-CENTURY-OLD PROHIBITION ON PAYMENT OF INTEREST ON DEMAND DEPOSITS, WHICH HAS LED TO A PATTERN OF BANKING PRACTICES DESIGNED TO CIRCUMVENT THE RESTRICTION. COMMERCIAL BANKS OFFER VARIOUS PROCESSING AND TRANSFER SERVICES TO THEIR LARGE COMMERCIAL CUSTOMERS IN ORDER TO COMPENSATE FOR THEIR INABILITY TO PAY EXPLICIT INTEREST ON THE DEMAND DEPOSITS. BUT THESE BENEFITS TO LARGE COMMERCIAL DEPOSITORS ARE NOT NECESSARILY AVAILABLE TO SMALLER BUSINESSES, PARTNERSHIPS AND CORPORATIONS. WOULD IT NOT BE FAR MORE EQUITABLE TO PERMIT THE PAYMENT OF EXPLICIT INTEREST ON DEMAND DEPOSITS? WE BELIEVE THAT IT WOULD BE, AND THEREFORE SUPPORT PASSAGE OF H.R. 3535.

ADDITIONAL DEREGULATION EFFORTS

NO DOUBT YOU ARE AWARE OF VARIOUS EFFORTS TOWARD A MAJOR REWRITING OF THE COMMERCIAL BANKING AND SAVINGS AND LOAN HOLDING COMPANY LAWS. IT WOULD APPEAR THAT THE PRINCIPAL FOCUS FOR THIS AT THIS POINT IS ON H.R. 3537 (S. 1609) -- KNOWN AS THE FINANCIAL INSTITUTIONS DEREGULATION ACT -- WHICH WAS INTRODUCED AT THE REQUEST OF THE TREASURY DEPARTMENT. THE OUTLOOK FOR THIS LEGISLATION IS RATHER MURKY TODAY, AND BECAUSE

OF THIS UNCERTAINTY, I AM NOT IN A POSITION TO COMMENT ON SPECIFICS. HOWEVER, I WOULD LIKE TO ADDRESS, GENERALLY, A FEW OF THE STRUCTURAL DEREGULATION TARGETS WHICH ADVOCATES OF THESE MEASURES HAVE ADVANCED.

THIS LEGISLATION WOULD WEAKEN OUR SERVICE CORPORATION POWERS SUBSTANTIALLY. OUR HOLDING COMPANIES' AUTHORITIES WOULD BE CURBED. AND CONTROL OF ANY NEW ACTIVITIES WOULD BE TAKEN AWAY FROM THE FEDERAL HOME LOAN BANK BOARD AND BE GIVEN TO THE FEDERAL RESERVE BOARD.

OVER THE PAST HALF CENTURY OUR SAVINGS INSTITUTIONS HAVE PROVIDED A RELIABLE FLOW OF HOUSING FINANCE TO THIS NATION'S ECONOMY. OUR FEDERAL HOME LOAN BANK SYSTEM HAS WORKED WELL, AND THERE IS NO GREATER EVIDENCE OF THAT THAN THE FACT THAT IT WAS THAT SYSTEM THAT HELPED OUR INSTITUTIONS SURVIVE THE DESTRUCTIVE YEARS OF 1980-82.

IT IS OUR DESIRE THAT THE FEDERAL HOME LOAN BANK SYSTEM BE PRESERVED, THAT THE POWERS UNDER WHICH WE PRESENTLY OPERATE NOT BE DIMINISHED, AND THAT OUR SPECIALTY FINANCIAL INSTITUTION STATUS REMAIN, SEPARATE FROM THE COMMERCIAL BANKING SECTOR.

THANK YOU, MR. CHAIRMAN, FOR THE INVITATION TO APPEAR BEFORE YOU TODAY. I LOOK FORWARD TO YOUR QUESTIONS.

U.S. League of Savings Institutions
Homeowneship Task Force
Donald F. Wall/Chairman

DISCUSSION PAPER 1

The Challenge to Homeownership in the 1980s

About this paper...

The United States League of Savings Institutions Homeownership Task Force was created in November 1982 to develop and advocate programs to assure that homeownership again becomes accessible to most Americans.

In announcing the task force, U.S. League Chairman Leonard Shane, of Huntington Beach, Calif., said the group would propose vehicles to permit and facilitate reestablishment of homeownership as a "top national priority."

Members (listed at the end of this paper) were appointed from savings institutions across the nation, and the League brought in as senior consultant Jay Janis, former undersecretary of the Department of Housing and Urban Development and past chairman of the Federal Home Loan Bank Board.

This task force discussion paper, "The Challenge to Homeownership in the 1980s," is the first in a series to be issued through the summer months and into the fall of 1983.

Additional copies are available at $5 plus postage and can be obtained by writing to the Order Processing Department, U.S. League of Savings Institutions, 111 E. Wacker Drive, Chicago, Ill. 60601.

July 6, 1983

Copyright 1983, United States League of Savings Institutions

This first in a series of reports of the Homeownership Task Force of the United States League of Savings Institutions was prepared amid a growing belief in this country that housing has finally turned the corner—and that rising production and sales signal the start of the long-awaited cyclical upswing.

This perception of a housing recovery is conveyed in many news stories and by reports from the government and from real estate brokerage offices, where resales in the first five months of 1983 were the best since 1979.

Interest rates have plummeted by nearly four percentage points in eight months, home builders are applying for construction permits at record-setting levels, lenders are flush with cash, and the Federal Housing Administration and the Veterans Administration can barely keep up with the rising pace of government-backed mortgage demand.

While a few reports convey an uneasiness with the true magnitude and potential longevity of the recovery, the conventional wisdom holds that housing is on its way back to many years of prosperity and that many Americans can look forward to their own homes soon. After all, such strong economic signs couldn't be wrong.

Yet in many important respects, our task force concluded that the signs *are* wrong.

We found that the economic realities for home buyers are nowhere near as bright as the conventional wisdom suggests—and that the much-ballyhooed "recovery" is far more fragile than the prevailing popular perception.

Moreover, that popular perception tends to make us complacent, not only about the current prospects but also about this nation's ability to meet its homeownership commitment for the balance of this decade and beyond.

All of us want very much to believe that what happened in the last three years was merely a temporary setback in our quest for affordable housing for our citizens. But the very factors that caused the severe real estate and housing recessions of the last few years persist, and profound changes in the home finance delivery system have substantially altered the opportunity for homeownership. Accompanying this change in homeownership opportunity is the threat of a much greater change in lifestyle than the social or political systems would accept.

These changes include the deregulation of savings institutions and savings rates, prompted by the popularity and rapid growth of unregulated financial entities. Specifically, deregulation has contributed to the shortening of deposit account maturities at financial institutions, which inhibits long-term lending and introduces into the system a built-in mismatch of assets (loans) and liabilities (deposits).

In the past, some regulations have provided a measure of assurance of homeownership opportunity as a national priority, but this old system is no longer at work.

While deregulation assures that savers will be paid market interest rates, housing must operate in a less favorable environment than in the past. This is so because home buyers must compete in the open market for capital with bidders able to preempt the market at any part of the interest rate cycles, which now feature unprecedented volatility and a premium on short-term credit.

Housing credit is different from other types of credit and, therefore, in the eyes of many observers, isn't suited to competing in "auctions" for credit. Home buyers, for example, must repay their loans from a stream of income which is not usually affected by the borrower's use of the assets. The cost of business borrowings, on the other hand, can be passed through and recovered quickly by means of price adjustments for the goods and service produced from the assets purchased with the borrowed funds.

These changes represent deep structural cracks in our housing delivery system, which will not repair themselves and which are beyond the capacity of a free market to fix.

In fact, the thrust of this report is that not only are the structural problems which caused the debacle in home finance in 1979-1982 still with us, but, more importantly, other new trends are emerging which potentially pose a far more serious threat to our national housing policy goals over the next several years.

We believe that the nation must recognize these negative trends as challenges to homeownership opportunities and take steps to offset them with carefully devised programs.

Indeed, our task force concluded that the longer term outlook for homeownership—spanning the years 1984 through 1990—is a sobering one, even under optimistic scenarios regarding interest rates, unemployment and inflation.

Look beyond the surface impressions of the housing rebound—as this task force has done through intensive analyses undertaken since December 1982—and you begin to find facts that demand greater public awareness.

You find, for example, that:

- The ratio of homeownership in the United States has declined by nearly a full percentage point in the 1980s thus far and could well remain depressed for years. This decline ends the steady, unbroken growth in homeownership ratios extending from the 1940s—a pattern that four major recessions didn't interrupt. *The drop in the national ratio of homeownership since 1980 has been so dramatic, in fact, that it has wiped out more than half of the gain registered during the 10 prior years—a decade known for its high housing production and sales levels.*
- Contrary to present appearances, housing affordability remains a severe problem for a large percentage of would-be buyers, and will continue to be so, even under the most sanguine interest rate scenarios. *By 1984, even if median home prices remain constant at their 1982 levels—a highly unlikely event—and mortgage rates drop to 11%, the gap between what the typical first-time buyer can afford to pay and the price of the median-cost new home will still be $14,000.*

Compare that with earlier periods when homeownership was expanding rapidly, such as the mid-1970s, and you begin to understand why fewer first-time purchasers will be able to make the jump from renting to ownership than popularly perceived. The affordability gap in 1977 was just $2,400. First-time buyers next year will face a gap five times as large—if they're lucky.

If the outlook for buyers and especially first-time buyers is so grim generally, it is dreadful for the specific segments of the population who in the past have had little homeownership opportunity. Purchasers from traditionally disadvantaged sectors of the market, particularly the poor and the disabled, modest-income elderly and minorities, may run out of opportunity entirely.

- A heretofore little-noticed demographic mismatch will limit saving accumulation in the United States during the coming several years—putting a severe strain on the availability of capital for home mortgage finance. The mismatch involves the rapid expansion in the population of consumers in the prime borrowing age bracket (25-44)—these creating demand for credit—relative to the number of individuals in the prime saving age bracket (45 and over)—those providing the supply of funds. During the next several years, the U.S. economy will see the smallest percentage of Americans in the prime saving bracket during any period in the second half of the 20th century. *That demographic mix inevitably will jeopardize the rate of savings in the economy overall and inevitably will reduce the supply of lendable funds for home buyers. Rising demands for progressively scarcer funds will then exert significant upward pressure on mortgage interest rates as well as other forms of long-term major credit.*
- *The prospect for a severe shortfall of capital in this country for the coming years casts an ominous shadow over homeownership opportunities through the remainder of the 1980s.* Using mildly optimistic assumptions about inflation, interest rates, growth in GNP, housing starts and sales, and decline in unemployment during the balance of this decade, the task force's economic analysis projects a net capital shortfall on the order of $100 billion to $240 billion per year for the economy as a whole during the next five years. The shortfall of capital will be closed through either a reduction of demand for credit or an increase in credit supply or both. This closing of the gap can occur by means of higher interest rates, slower GNP growth, and fewer housing starts and sales than generally anticipated. Whichever of these occurs, the impact on homeownership opportunities will be negative.

The capital shortage will result largely because of the inability of Congress and the administration to exert self-discipline and control over the size of federal budget deficits. Deficits even half the magnitude of the $200 billion-plus levels now projected will prevent tens of thousands of American households from purchasing a home. Rather than functioning as a promoter of homeownership—its traditional role—the federal government will become a massive impediment: It will siphon away the capital many of its citizens would otherwise borrow to buy homes. Rather than consuming nearly one out of every two dollars available in the capital markets—as at present—the federal government will need to cut its share to one out of every five dollars to prevent harm in the next three years to residential borrowers.

In human terms, the price of the current lack of fiscal discipline in Washington will be steep. In social and political terms, the price could be even steeper.

- Despite the often-expressed hopes of those who look to pension funds and insurance companies to take up the slack in the mortgage market, close analysis shows that these institutions could supply no more than 10% to 20% of mortgage finance requirements this year and even less in 1984. Moreover, the capital markets altogether can only supplement the core suppliers of housing credit. While it would be foolish to ignore the potential of these sources of funds for the homeownership market, it would be equally foolish to presume that what is not supplied by the traditional lending institutions is going to be drawn from this very limited well.
- Home building is both more seasonal and more cyclical than most other industries. These characteristics make the construction process less efficient and therefore more costly. While the seasons are beyond human control, housing's cyclicality is largely due to factors which we can affect, such as production of building supplies and raw materials and the interest sensitivity of mortgage demand. Government's heavy—at times almost exclusive—reliance on monetary policy to control inflation and the nation's orientation toward the fixed rate mortgage have contributed significantly to this cyclical phenomenon. When rates are perceived as being "high," home buyers stay out of the market. Production declines both at the home building level and at the builder supply level. When rates drop to "low" levels, buyers rush into the market putting pressure on an industry whose capacity is down. *Cyclicality in the home building industry can be reduced through widespread use of adjustable mortgage instruments which do not force home buyers to gamble on low points in the interest rate cycle but rather allow them to enter the market at almost any time.*
- The shortening of maturities on popular savings instruments, not only at depository institutions but in virtually all financial entities, has resulted in a shrinking of the supply of long-term lendable funds. Fixed rate mortgage loans made with overnight money are generally being sold through the secondary mortgage market. But only 2% to 3% of the total have been purchased by institutional investors in the capital markets. This "maturity warp" over time may prove to be only a minimal or transitory obstacle to homeownership opportunities, but for now, financial institutions must learn the true nature of these accounts before prudence will permit commitment to long-term loans—even long-term loans with some rate adjustment features.

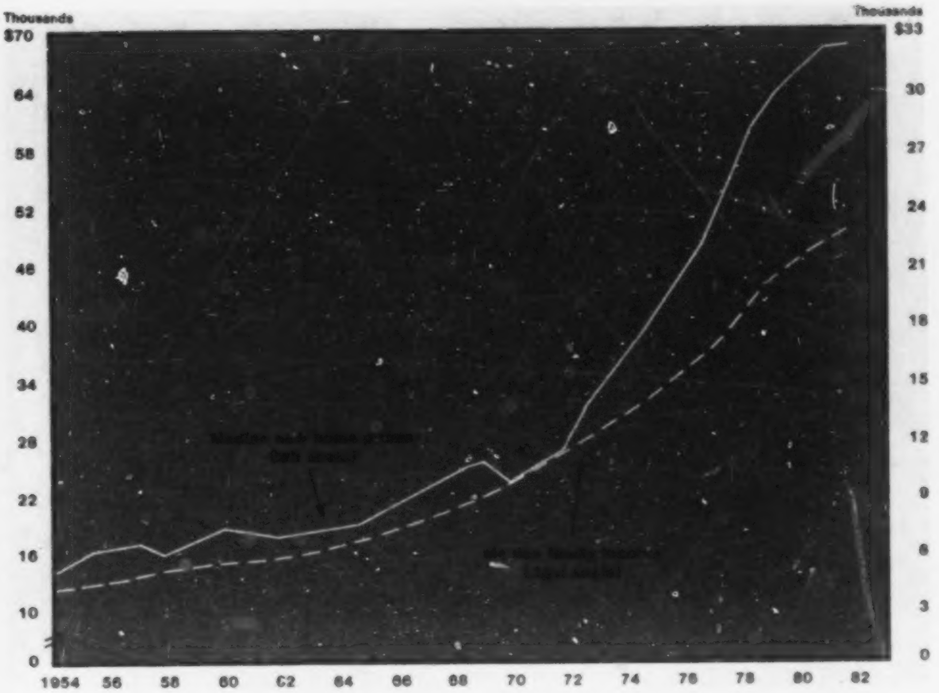
Not all the task force findings are discouraging. We assert, for example, that, contrary to some conventional wisdom on the subject, savings institutions are going to remain primarily home finance experts, doing a major portion of the home mortgage business in the United States, despite the addition of new, nonmortgage types of authorities in federal laws passed in 1980 and 1982. Financial institutions with specialized knowledge and experience can better serve people's special needs.

The statistical facts that underpin these and related findings of the task force are worth examining at greater length. This report will take a look at several of the areas of economic analysis, and then discuss the public policy implications of the emerging challenges to homeownership in the United States during the balance of the 1980s. The task force's entire set of findings will be released in a series of discussion papers during the summer and fall of 1983.

AFFORDABILITY: THE PRESENT—AND FUTURE—GAPS

The pervasive glow that surrounds most discussions of the home real estate "rebound" this year masks the hard realities facing the bulk of prospective home buyers: Interest rates may be down and housing prices may have flattened temporari-

CHART 1
HOME PRICES VS. INCOME



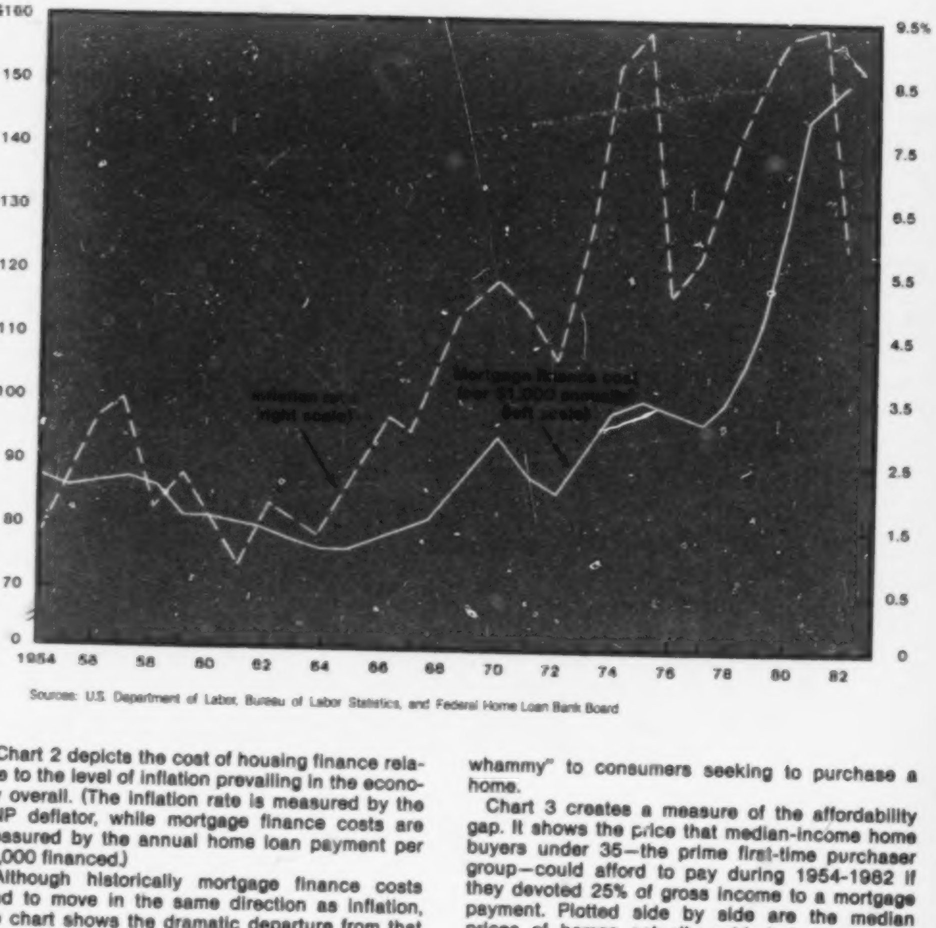
Sources: U.S. Department of Commerce and U.S. League of Savings Institutions

ly, but the fact remains that purchasing a home is still a financial impossibility for millions of consumers *who would have been qualified in prior years.*

The housing affordability conditions that faced buyers in past decades are depicted in Charts 1, 2 and 3. They track home prices, family income and mortgage terms back to 1954.

Chart 1 illustrates the relationship over the last 30 years between median family income and median new home prices. For nearly two decades, the growth in family incomes kept pace with—and for four years equalled or exceeded—the growth in new home prices. Beginning in 1973, however, the median price of new houses began to accelerate sharply relative to family incomes culminating in the massive price gap buyers experienced by the end of 1982.

CHART 2
FINANCING COSTS



Sources: U.S. Department of Labor, Bureau of Labor Statistics, and Federal Home Loan Bank Board

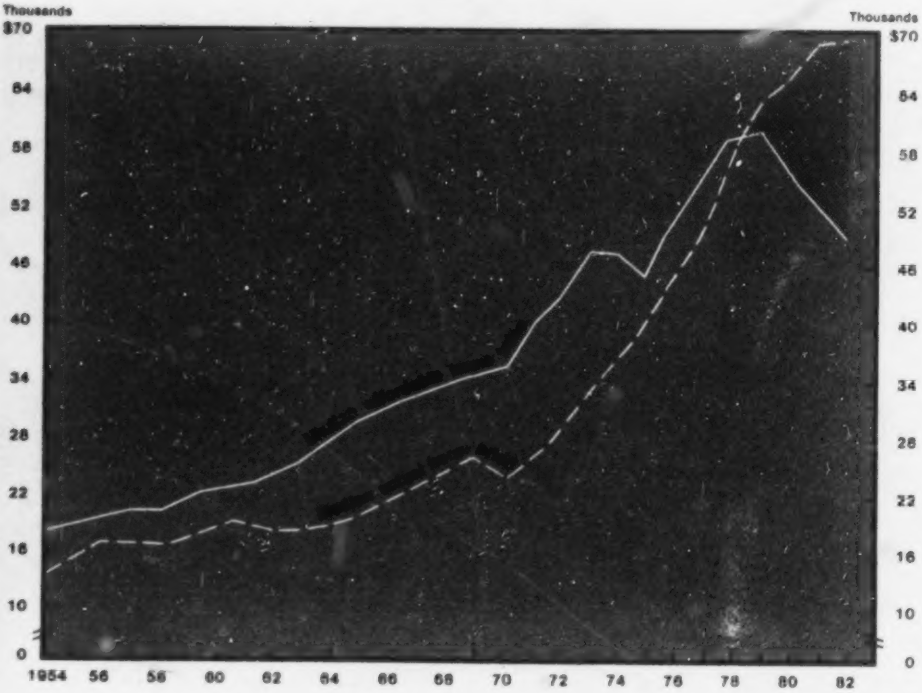
Chart 2 depicts the cost of housing finance relative to the level of inflation prevailing in the economy overall. (The inflation rate is measured by the GNP deflator, while mortgage finance costs are measured by the annual home loan payment per $1,000 financed.)

Although historically mortgage finance costs tend to move in the same direction as inflation, the chart shows the dramatic departure from that pattern that began in late 1981—and continues to this day. The price of financing, plus accelerating prices of houses, delivered a devastating "double-whammy" to consumers seeking to purchase a home.

Chart 3 creates a measure of the affordability gap. It shows the price that median-income home buyers under 35—the prime first-time purchaser group—could afford to pay during 1954-1982 if they devoted 25% of gross income to a mortgage payment. Plotted side by side are the median prices of homes actually sold during the same year.

As the data demonstrate, throughout most of this 30-year period American consumers have enjoyed a "positive margin of affordability" between what their incomes permitted them to buy and what was available on the marketplace.

CHART 3
THE AFFORDABILITY GAP



Sources: U.S. Department of Commerce and U.S. League of Savings Institutions

In 1979, however, that margin disappeared. Rather than a fleeting, momentary distortion caused by the pincer effects of high inflation and high housing prices, the gap now shows signs of becoming a long-term presence in the housing equation.

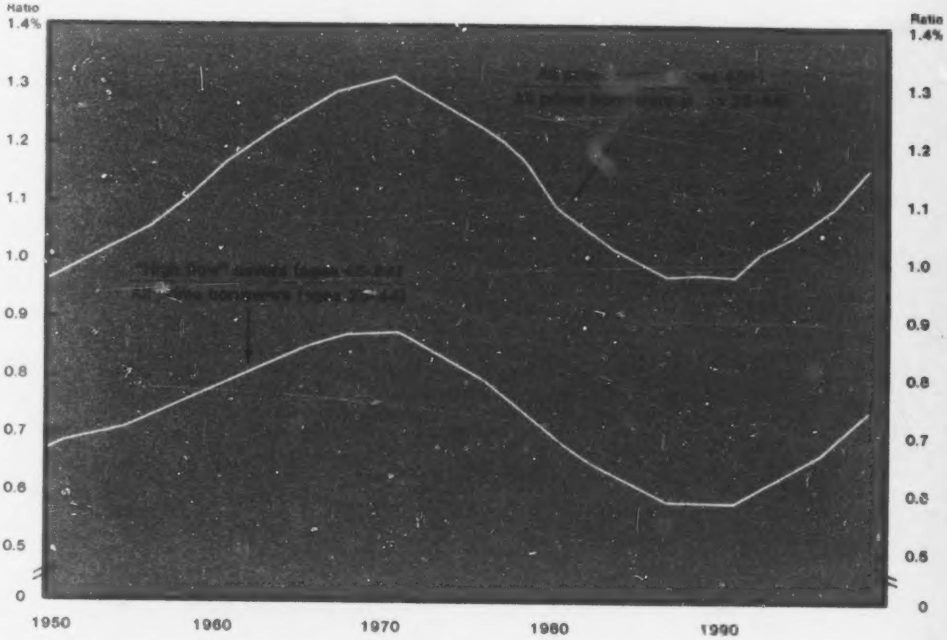
Despite the fact that by late 1982 the rate of inflation was sharply on the decline, the affordability gap for house buyers has barely narrowed in 1983. The factors that prop the cost of homeownership up despite moderating inflation are rooted in the systems of housing construction and home financing. One of the most difficult is cyclicality—the tendency of housing producers and construction materials suppliers to "aim for the low points" of housing production cycles and thus create chronic mismatches of supply and demand, leading to higher prices for homes.

Moreover, mortgage interest rates registered a relatively small decline, compared with inflation. During 1982, home loan rates averaged 14.75%, a postwar high. During 1983, by comparison, they will likely average 12.5% to 13%.

In terms of hard savings to the consumer, the drop to 12.5% will mean a cost decline from $150 per $1,000 in mortgage debt to $129 per $1,000.*

*Assuming a 28-year average term.

CHART 4
RATIO OF PRIME SAVERS TO PRIME BORROWERS



Sources: U.S. Department of Commerce and U.S. League of Savings Institutions

Although highly welcome, that reduction doesn't really make a sizeable dent in the affordability problem. To return to financial cost levels of 1978, just prior to the onset of the affordability gap, the economy would have to offer 10% fixed rate loans—a drop that few, if any, economic analysts consider feasible.

Alternatively, family income for buyers below the age of 35 would have to jump 22%, while mortgage rates remained at 12.5%—again not likely in the coming year (or even in the coming several).

The only other scenario that would close the gap would be a drop in median new home prices from $69,300 for 1982 to $62,000 (a 10% decline), while mortgage rates remained frozen and median family income rose 6%.

Obviously, the gap not only persists, but is substantial. As mentioned earlier, it is likely to be a $14,000 chasm confronting the median first-time buyer in 1984, even under optimum assumptions regarding federal deficits, inflation and interest rates.

THE DEMOGRAPHIC DILEMMA: LOWER SAVINGS, LESS MORTGAGE MONEY, HIGHER HOUSING DEMAND

Everyone who pays attention to housing is familiar with one of the most widely publicized demographic "events" of the decade: The arrival of the largest mass of the "baby boom" generation into the prime home buying age category. Some 42 million Americans, more than one out of every six people in the country, will reach the age of 30 during the 1980s. The decade of the 1970s, by comparison, saw *10 million fewer* people enter that age bracket.

The implications of the baby boom surge for housing have been chronicled at length. More people entering the prime home buying period in their lives will mean more home building, more home sales, more home furnishing and more home mortgages. The demographic outlook at first glance is upbeat.

But there is another side to this phenomenon that hasn't received the attention it deserves. It is what can be called the demographics of saving behavior, or the life cycle of saving.

As shown in Table 1, different age groups in the American population exhibit significantly different behavior patterns when it comes to saving money. Based on extensive field surveys of depositors conducted at savings institutions across the country during 1982, it is possible to quantify the life cycle of saving.

The people who save the least—and in fact are often net borrowers rather than savers at all—are households in the 25- to 44-year-old grouping. Although a family's income may rise sharply during these years, so do expenses—and those purchases typically rely heavily on credit.

TABLE 1
THE LIFE CYCLE OF SAVING

Age Group	Median Household Income	Median Expected Household Saving	Implied Saving Rate
18-24	$18,544	$ 840	4.5%
25-34	28,476	1,267	4.4
35-44	35,730	1,687	4.7
45-54	36,620	2,310	6.3
55-64	31,188	2,949	9.5
65 and over	22,081	2,490	11.3

Source: U.S. League of Savings Institutions, Economics Department

The cycle begins to shift perceptibly once we move into the 45- to 54-year-old category. By then, some (if not all) of the children are completing their educations, moving out on their own. Typically, personal incomes are reaching career highs, while expenses such as home mortgage, automobile and other major debts are coming under control. People begin to save money and build the financial base for their retirement.

The next phase—ages 55-64—represents the highest saving years in terms of net dollars. Household income may begin to decline, but standard household expenses tend to decline even faster.

Retirement years—generally 65 and over—tend to produce the highest percentage of saving rates of our lives, though not necessarily the highest dollar totals. Incomes by now are markedly on the decline, but expenses continue to be low relative to other points in the cycle.

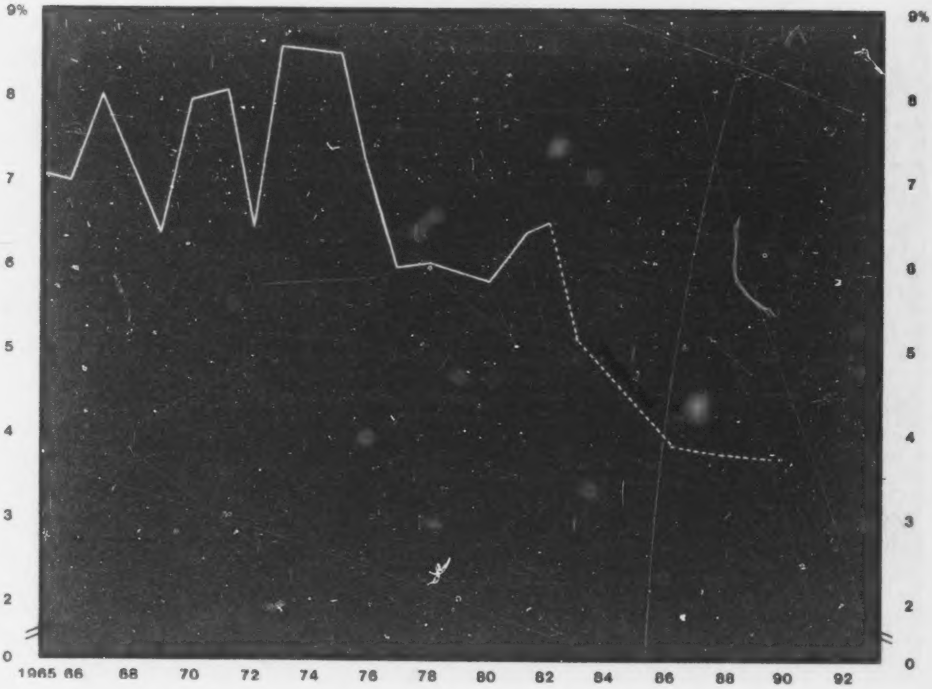
The relevance of the personal saving cycle to housing prospects is compelling and direct.

As Chart 4 reveals, the next several years will witness the least favorable demographic mix of savers and spenders in the overall population in decades. *Proportionally there will be far more consumers with high credit needs in the marketplace, and far fewer high savers to provide capital for those needs, than at any time in recent history.* Adding to the problem of an unfavorable demographic mix of savers and borrowers is the decline of contingent reasons to save in today's society. More people have pensions or rely on Social Security. Readily available lines of consumer credit, easily accessed with plastic cards, reduce dependency on savings as a source of emergency cash. But the major cause of savings shortage can be traced to the saver/spender imbalance.

To get perspective on this, consider the years of the late 1960s and early 1970s. The Census Bureau says that in 1971 there were 1.31 prime savers in the population for every prime borrower. By 1982, the ratio had dropped to about 1:1. By 1987, when the demographic cycle hits bottom, there will be only .89 prime saver for every prime borrower. (After that, the ratio begins to move up again sharply, as the baby boom spenders change into net savers.)

Put bluntly, the demographics of the mid-1980s will cut the rate and relative availability of person-

CHART 5
ACTUAL AND PROJECTED PERSONAL SAVING RATES



Source: U.S. League of Savings Institutions

al savings—reductions that will have special significance for residential real estate. Although personal savings represent about 28% of total private sector savings, they have traditionally been crucial to housing finance. *Funds supplied by personal savings have exceeded the total requirements of housing investment in the U.S. in all but nine out of the 22 years between 1960 and 1981.*

Using the life cycle of saving and demographic data, the task force's economic analysis projects a decline of the national personal saving rate to 3.8% within the next five years.**

If that occurs—and the federal deficits remain anywhere near currently projected levels—*there will be an acute shortage of funds for housing by the mid-1980s.* Moreover, such conditions of capital shortage will force interest rates to climb dramatically from current levels. Not only would

---

**Assumes an average rate of growth of real disposable income of 3% a year, average unemployment rate of 7%, average after-tax rate of return of 6%.

home buying opportunities for the average resale purchaser diminish; first-time buyers would be virtually excluded from the market by prohibitive rates, as occurred in 1981-1982. The decline in the national rate of homeownership would begin again.

COMPETITION FOR CAPITAL: HOUSING'S INADEQUATE SHARE

Although it became fashionable in some quarters at the height of the residential real estate boom of the late 1970s to denounce housing for consuming too much of the nation's capital, the statistical picture has now cleared (See Table 2).

Housing's share of total investment during the 1970s was 27.5%, compared with the 32.5% it consumed in the 1950s. By comparison, business investment in plant, equipment and inventory accounted for 62.8% in the 1950s and 68.8% in the 1970s.

What about the 1980s? How big a slice of the capital pie is housing gobbling up thus far, and what is the outlook through the decade?

The answers, contrary to popular notions, are that housing's share of total investment has slipped dramatically in recent years.

TABLE 2
PRIVATE RESIDENTIAL AND BUSINESS INVESTMENTS AS PERCENTAGES OF TOTAL PRIVATE INVESTMENT IN THE UNITED STATES
1950-1982

Year	Total Residential Investment	Total Business Investment
1950	35.3%	60.8%
1951	27.7	65.4
1952	32.0	62.2
1953	33.7	63.9
1954	36.3	59.1
1955	33.5	62.3
1956	29.2	63.8
1957	27.3	63.1
1958	32.8	62.1
1959	33.4	64.8
1960	30.1	63.2
1961	30.1	61.8
1962	29.4	63.7
1963	30.6	61.7
1964	28.6	62.0
1965	25.3	67.5
1966	21.6	73.5
1967	22.2	73.0
1968	25.3	71.6
1969	24.9	72.4
1970	24.6	71.0
1971	29.8	67.8
1972	32.6	67.0
1973	27.9	66.3
1974	23.9	70.5
1975	23.7	64.7
1976	26.5	68.4
1977	29.9	71.3
1978	28.8	71.4
1979	27.2	69.8
1980	24.1	70.0
1981	21.1	73.7
1982	21.9	74.4

Source: U.S. Department of Commerce

TABLE 3
PRIVATE SAVING AND PRIVATE INVESTMENT
1950-1982
(Billions of Current Dollars)

Year	Total Private Saving	Total Private Investment	Private Investment as a Percentage of Private Saving
1950	$ 44.8	$ 56.1	125.2%
1951	55.3	63.6	115.0
1952	58.0	55.3	95.3
1953	58.0	54.6	94.1
1954	60.6	55.3	91.3
1955	67.3	71.4	106.1
1956	76.0	76.3	100.4
1957	81.6	76.5	93.8
1958	81.9	65.2	79.6
1959	84.3	79.6	94.4
1960	85.7	81.5	95.1
1961	90.7	81.4	89.7
1962	95.3	91.9	96.4
1963	97.9	98.5	100.6
1964	113.6	107.4	94.5
1965	125.7	122.3	97.3
1966	133.1	132.2	99.3
1967	143.5	129.1	90.0
1968	145.7	137.7	94.5
1969	149.5	153.5	102.7
1970	169.4	150.9	89.1
1971	187.3	170.6	91.1
1972	194.2	195.7	100.8
1973	259.2	244.0	94.1
1974	276.4	242.0	87.6
1975	331.1	232.9	70.4
1976	336.5	271.7	80.7
1977	350.4	320.0	91.3
1978	409.7	385.5	94.1
1979	478.3	436.3	91.2
1980	524.3	427.6	81.6
1981	572.2	497.6	87.0
1982	561.6	438.4	78.1

Source: U.S. Department of Commerce

Residential spending represented barely 21.1% of total private investment in 1981, a post war record low. In 1982, it rose to just 21.9%.

Business investment in plants and equipment and inventory, by contrast, rose to highs of 74.4% and 73.7% in 1982 and 1981, respectively.

Compounding housing's shrinking share of the nation's capital resources is the federal government. Its mushrooming deficits are home buyers' and sellers' number one threat in the money market today. The government's financing needs now siphon private savings away from highly productive private investment—like home mortgages—into generally less productive public sector expenditures.

During the 1950s, an annual average of 99.5% of private savings flowed directly back into private investment. In 1982, as Table 3 indicates, that proportion fell to 78.1% due primarily to the rapid growth of the federal deficit.

When the government's appetite grows so voraciously without apparent restraint, other credit users like homeowners not only have to stand back farther in line, but become increasingly vulnerable to higher rates and a net capital shortage.

That shortage, according to the projections of our economic forecasts, is on the verge of turning critical for the home mortgage sector.

Large federal deficits, fundamental changes in the system of home financing, declining private savings rates and a moderately expansive national economy are pointing to a serious potential shortage of long-term capital in the United States that will become painfully evident by 1984.

Only if the national savings rate can be increased, the deficits controlled and broader sources of reliable funds for the home mortgage market developed will American home buyers and sellers be spared the brunt of the credit crunch in the months and years ahead.

AN ACTION AGENDA TO SAFEGUARD AMERICAN HOMEOWNERSHIP IN THE 1980s

Dispassionate, probing examination of the economic prospects for homeownership in this country—something this task force has been doing for six months—cannot but lead to alarming conclusions.

Optimistic headlines about housing's rebound notwithstanding, homeownership opportunities for millions of Americans are in jeopardy.

The problems of capital shortage and affordability confronting homeownership cannot be lightly dismissed or wished away. They will not disappear by allowing government policies and private market forces to continue on their current paths. The rising tide of the nation's economic recovery alone will not raise homeownership's prospects.

Left unaltered, in fact, the economic and public policy trends we see taking shape will abort the housing recovery, encourage needless increases in mortgage rates and depress the rate of homeownership rather than increase it.

We believe that everyone in the United States with a stake in homeownership—Congress, governments at all levels, the housing and finance industries, and the general public—needs to understand the facts and to consider a course of corrective action.

Over the coming months, we will publish additional discussion papers designed to promote a widespread debate on these issues and ultimately point toward such a corrective course, based on our research and deliberations.

To provide a preliminary sense of the scope and direction of our findings, however, we will highlight some of our initial recommendations here. By doing so, we hope at least to stimulate discussion on the issues confronting American homeownership. We further seek to encourage those who already recognize the problems and are prepared to take creative steps to solve them.

RECOMMENDATIONS TO COPE WITH THE COMING CAPITAL SHORTAGE

Probably the most significant single challenge looming over the horizon for home buyers and sellers is the credit crunch of the 1984-1988 period. As noted earlier in this paper, the capital shortage will be the inevitable product of unrestrained federal deficits in an expanding economy, plus steady erosion in the national rate of savings. The latter phenomenon is directly linked to the unfavorable demographics of saving behavior developing in the United States population. It is noteworthy that despite the great inflow of funds to the financial institutions' money market deposit accounts in the early part of this year, the nation's saving rate for the first quarter of 1983 still declined from the prior quarter (from 6.0% to 5.9%). The money flowing into these accounts, moreover, is not necessarily going to be available to would-be home buyers. Many lenders are reluctant to use one-day money for long-term loans.

No one, of course, can change our immediate demographic future. Enlightened public policy, however, *can influence the rate of saving.* Public policy can change the mix of incentives so that households in the lowest saving age bracket—the 18-44 grouping—receive the same encouragement to save funds as those in older age brackets already receive.

Current American tax incentives for saving aim their appeal at upper income households—through individual retirement accounts (IRAs), Keogh and private pension plans. We strongly believe that if the national rate of saving during the next four years is to be retained at the levels necessary to support credit demands for homeownership, additional tax incentives will be needed that direct their greatest benefits at younger, lower income households—particularly first-time home buyers.

The form such incentives could take will be addressed in later task force papers. It may be individual housing accounts (IHAs) or some other targeted tax program that would not add net new revenue expenditures to the federal budget. Suffice it to say at this point that *without some change in current policy, the margin of safety that private savings deposits historically have provided for home mortgage borrowers will evaporate.*

RECOMMENDATIONS TO ENHANCE HOME BUYERS' ABILITY TO COMPETE FOR CAPITAL

The strength of the historical position of homeownership is that it has been based upon not a subsidy but an advantage for home buyers. The challenge now is to discover ways to recreate in a deregulated environment some form of nonsubsidized advantage for homeownership.

For America's home buyers to have a chance to compete for their fair share of the nation's capital resources during the coming years of credit scarcity, we believe several policy steps need to be taken now.

First, public and private sector leaders must work together to streamline the American system of housing finance, with particular emphasis on creating new mortgage vehicles attractive to institutional investors.

One such approach with a high potential for success is the taxable certificate of deposit-backed bond (CDBB).

The CDBB concept involves raising funds in the taxable bond market, using the bond proceeds to purchase federally insured jumbo certificates of deposit and financing individual home loans with the FSLIC-insured funds. Unlike use of the same technique in the tax-exempt arena, taxable CD-backed bonds create no revenue losses or increases in net liabilities for the federal government. To the contrary, our research indicates that widespread use of this capital-raising technique by savings institutions would actually cut FSLIC's risk exposure by enabling insured institutions to match the terms of their home loans better with the terms of their deposits. CD-backed bonds also offer the distinct possibility of lower loan rates to individual consumers, thanks to the FSLIC insurance backing bondholders' investments.

We believe that this innovative vehicle could draw institutional resources—especially private uninsured pension funds, local and state pension funds, and life insurance company assets—into home mortgage investments to a far greater extent than today. Pension funds and life insurance companies could become more important contributors to meeting the nation's homeownership finance needs, we conclude from our research, if attractive investment vehicles tailored to their specific requirements are offered to them. That broadened, supplemental role to existing capital sources could prove helpful to thousands of buyers in the years immediately ahead.

Along the same lines, we support continued federal and private efforts to reduce impediments to institutional investments in privately issued mortgage-backed bonds. The concept of "trusts for investment in mortgages" (TIMs), which seeks among other objectives to remove current federal tax disincentives for managers of mortgage pools, should be given very careful scrutiny to determine whether this program will in the long run enhance homeownership opportunities.

Second, the federal government should help rationalize and strengthen home finance by removing itself, once and for all, from the business of regulating FHA and VA interest rates.

An analysis of the patterns of FHA-VA rate movements during recent years leads to these conclusions:

(1) This highly visible rate index is subject to political manipulation designed to cast economic conditions in a favorable light—rather than actually assist consumers obtain financing at the lowest possible costs.

(2) The FHA-VA rate ceiling is often significantly below the market rate. This, in turn, forces home sellers to maintain or increase their sale prices to pay the required loan discount "points." FHA-VA's rate ceilings, in short, contribute unnecessarily to inflation in the cost of houses—a result diametrically at variance with the stated economic goals of the Reagan Administration.

(3) Below market fixed rate, long-term FHA-VA rates—such as the 11.5% rate set in May as market rates were heading back to 13%—serve to distort consumer demand. Buyers tend to pass by discount-priced adjustable mortgage loans (AMLs) offered in the conventional market when the FHA-VA rate is held at artificially low levels.

Third, savings institutions, the U.S. League, the federal government and the federal agencies involved in housing finance should actively promote use of the adjustable mortgage loan as the standard instrument for financing home purchases.

We believe that AMLs represent an absolutely essential tool for rationalizing housing finance in America. Not only do they enable lenders better to control their exposure to sudden increases in the cost of money, they are also lower cost vehicles in the long run for the home buying consumer than fixed rate loans containing inflation premiums. It should be recognized that the cyclicality in home finance, caused to some extent by the fixed rate mortgage, has been a major obstacle to homeownership in the recent past. Interest rate instability appears to be a fact of life for this country in view of the absence of interest rate regulation and the persistence of destabilizing influences such as large federal deficits, reliance on monetary policy to control inflation and demographic imbalances.

Fourth, in particular, the major federally chartered secondary mortgage market institutions—the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC)—should both work to promote adjustable mortgage loans and gain far greater acceptance of these loans among secondary market investors and the home buying public.

Properly priced and marketed, AMLs can and should be the principal form of home mortgage finance and can contribute to narrowing the affordability gap as well as reducing cyclicality. Proper pricing means AMLs should carry discounts below the prevailing quotes for fixed rate loans. That should help keep the home buyer's cost down. There is no formula for how large a discount is appropriate, and we would not suggest that anyone should prescribe one. Suffice it to say that, especially while fixed rate loans remain available, AMLs will have to be "sweetened" for reluctant home buyers.

FNMA has taken an important step in this direction recently by reducing the number of its AMLs to just three, which vary by maturity, and setting rate differentials not only between fixed rate conventional loans and adjustable loans, but also among the three maturities of AMLs. FNMA should continue to exercise leadership in popularizing the AML as the new standard home mortgage and should involve itself in the redistribution of AMLs among home lenders.

FHLMC should exercise leadership in its own right, and adopt a rational, differential pricing structure for AMLs as FNMA has done.

Only when adjustable loans become widely accepted by consumers—through pricing and marketing innovations—will their obvious strengths for investors become compelling to the secondary market.

Fifth, Congress should assist in rationalizing mortgage finance vehicles by enacting a federal preemption of all state prohibitions of prepayment penalties on long-term, fixed rate loans. The secondary mortgage market entities, FNMA and FHLMC, should strictly enforce prepayment penalties on long-term, fixed rate loans. Lending institutions in states where a federal preemption is exercised should be required to offer AMLs with no prepayment penalties.

Sixth, the Federal Home Loan Bank Board should restrict savings institutions' use of its long-term advances—which carry advantageous rates—to residential lending purposes (or to restructuring of liabilities backing residential loans) only. Any savings institution seeking advances of five years or longer should be required to hold in portfolio, or have commitments for, as much in residential loans as they seek in advances.

RECOMMENDATIONS TO CLOSE THE AFFORDABILITY GAP

The inability of millions of Americans during the coming years to afford a home—particularly first-time buyers, the elderly and other modest-income households—should be a matter of major national concern.

We urge Congress, local governments, the Reagan Administration and private industry to grasp the severity of the affordability threat now facing us, and to consider the damage a declining national rate of homeownership can wreak in a society like the United States.

The task force recommends the exercise of federal leadership to work with and offer incentives to state and local governments toward elimination of restrictions which unnecessarily raise the cost of housing, such as some of the restrictions found in many building and zoning codes and subdivision standards.

Regulatory authorities should avoid policies which tend to disadvantage manufactured housing at the mortgage window, and local officials should avoid placing undue restrictions on the acceptance and use of manufactured homes.

There are no quick fixes nor easy answers to the affordability problem. Having labored for months searching for answers, we must be frank to admit that closing the gap for consumers during this decade will require extraordinary cooperation between the private and public sectors.

But we are now convinced that it can be achieved.

It will require efforts to expand the availability and reduce the cost of mortgage capital, as we have discussed above.

It will require giving serious consideration to means of stabilizing credit in times of high interest rates and savings outflows. The financial system should be capable not only of providing the supply of credit to meet national needs in general but also of responding specifically where social-economic purposes are identified as matters of public policy, such as the policy of opening homeownership opportunities to the broadest possible spectrum of the American citizenry.

It will require creative approaches to provide homeownership for modest-income Americans, the elderly and the handicapped.

It will require homeownership again to assume its proper role—as an issue high on the list of national priorities—rather than be shunted aside as something the marketplace will handle in due course.

In due course, we assert, the marketplace will *not* solve the problem of affordability. It will *not* expand capital resources for mortgages, nor restrain prices of new homes.

Treat homeownership and affordability in the *laissez faire* manner of the past five years, and there will be less homeownership in America, not more.

None of us can be content with such a prospect.

Homeownership Task Force

Chairman

[illegible]

Vice Chairman

[illegible]

Members

[illegible]

Ex Officio

[illegible]

Senior Consultant

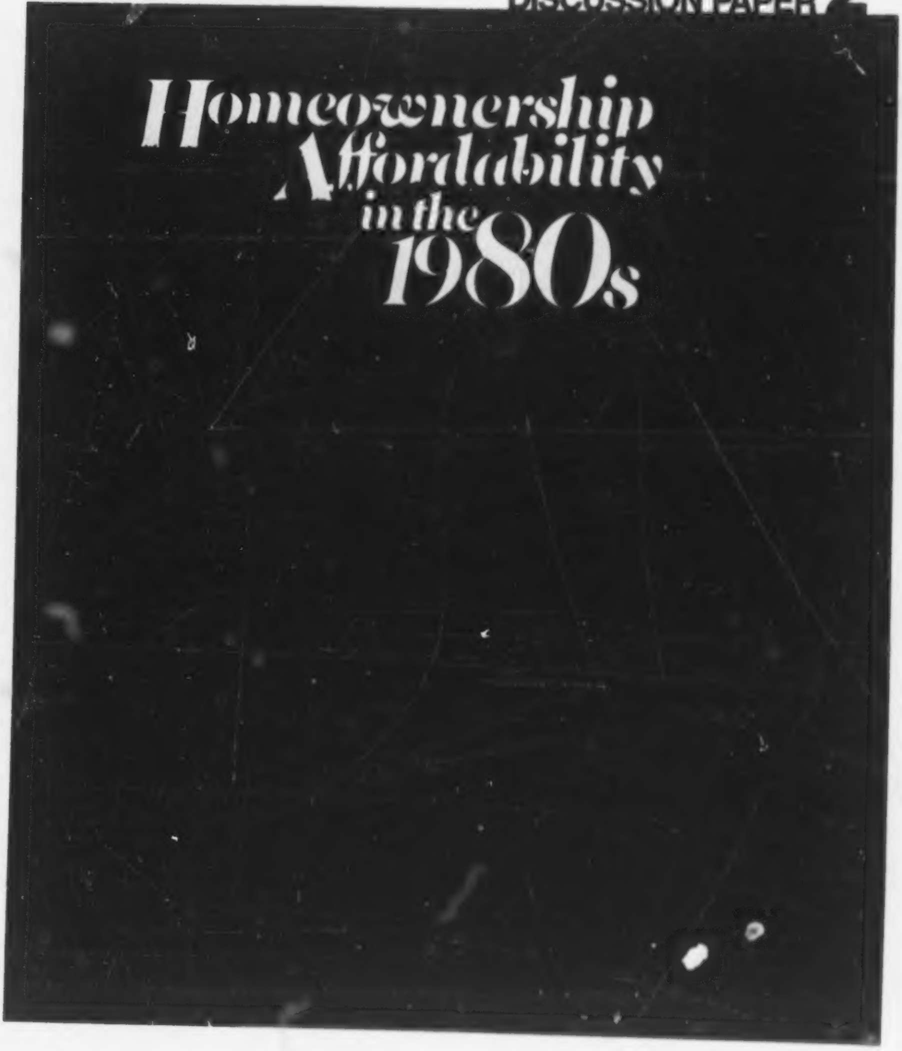
[illegible]

U.S. League Staff

[illegible]

U.S. League of Savings Institutions
Homeownership Task Force
Donald F. Wall/Chairman

DISCUSSION PAPER 2



Homeownership Affordability in the 1980s

About this paper...

The United States League of Savings Institutions Homeownership Task Force was created in November 1982 to develop and advocate programs to assure that homeownership again becomes accessible to most Americans.

In announcing the task force, U.S. League Chairman Leonard Shane, of Huntington Beach, Calif., said the group would propose vehicles to permit and facilitate reestablishment of homeownership as a "top national priority."

Members (listed at the end of this paper) were appointed from savings institutions across the nation, and the League brought in as senior consultant Jay Janis, former undersecretary of the Department of Housing and Urban Development and past chairman of the Federal Home Loan Bank Board.

This task force discussion paper, "Homeownership Affordability in the 1980s," is the second in a series. The first, "The Challenge to Homeownership in the 1980s," was published in July.

Additional copies are available at $5 plus postage and can be obtained by writing to the Order Processing Department, U.S. League of Savings Institutions, 111 E. Wacker Drive, Chicago, Ill. 60601.

September 22, 1983

Copyright 1983, United States League of Savings Institutions

The inability of millions of Americans to purchase even a modest home is the single, overriding challenge facing housing in this country today.

As the Homeownership Task Force documented in its first discussion paper, released in July 1983,* this widening gap between families' aspirations and the capacity of the American economy to deliver affordable housing has serious, long-range consequences.

When the national rate of homeownership (Chart 1) turns downward after four decades of steady upward movement—as it has done since 1980—we believe the time has come for policymakers to take a hard, searching look at the reasons why.

Denial of homeownership opportunities to large numbers of families who would qualify by all traditional measures of income and education adds up to a major, urgent concern for our society.

Millions of families will be forced to remain renters during the coming decade rather than become homeowners as they would have in previous decades. One expert, Arthur Young, the U.S. Census Bureau's chief of housing, estimates that this number could reach 10 million.

This is a shocking projection.

Vigorous though the current economic recovery may appear, it has not changed the downward course of homeownership as many economists believed it would. To the contrary: we may be on the verge of a new series of setbacks for homeownership. If mortgage rates and housing prices remain at or near their August 1983 levels during the coming 12 months, a further decline in American ownership of single-family homes will be the inevitable result.

Why are we experiencing such reversals at a time when consumer demand for homes is intense? Why are we going backward when, by all conventional tests, we should be surging ahead?

Those questions have been high on the agenda of the Homeownership Task Force throughout its eight months of research. In this paper, we offer a summary of a portion of our findings relating to the affordability of homes in the marketplace of the 1980s.

We examine, in particular:

- The contributing roles of housing prices, land prices, housing size and density;
- The impact of productivity and efficiency within the housing industry;
- The role of government regulation in higher housing prices; and
- The impact of mortgage financing availability, mortgage rates and alternative mortgage instruments.

We also suggest actions that we believe can help counter the growing problem of affordability—*provided there is a will to do so by policymakers in both the public and private sectors and at local and national levels.*

THE AFFORDABILITY EQUATION IN PERSPECTIVE

What makes a home "affordable"? Why did families with modest resources in the early 1960s find buying a typical new house relatively easy, while even two-earner couples with sizable incomes in 1983 are shut out of the market?

The answers seem obvious at first glance, but in reality they are more complicated. "Affordability" is the product of a dynamic equation in which the cost of money, families' disposable incomes, the cost of new and existing homes, and the rate of inflation interact over time.

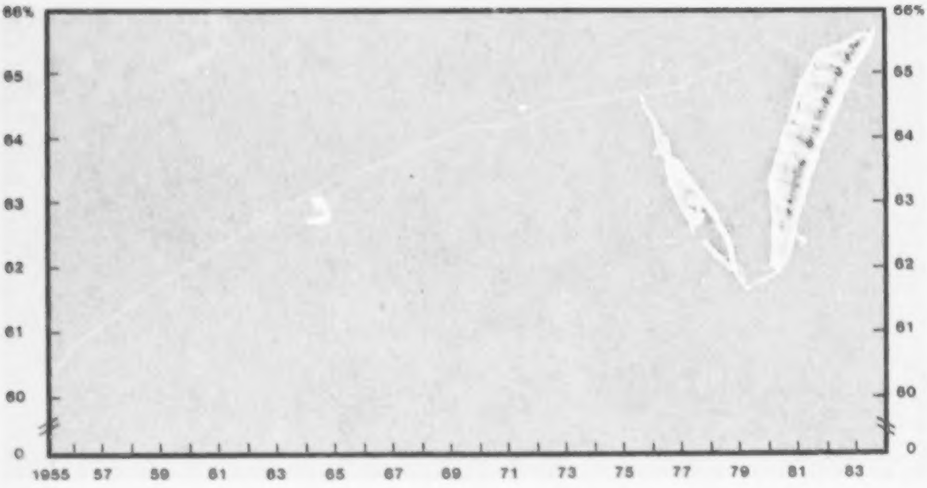
For nearly 40 years—from 1940 until 1979—these factors maintained a harmonic interrelationship. Home prices rose during many of those years, mortgage interest rates edged up over time, but families' real disposable incomes were able to keep up with—or even outdistance—increases in the other two. Taken together, the factors constituted a positive equation for homeownership opportunity.

The 1950s and 1960s were superb environments for that positive equation to work (See Chart 2). In 1956, for example, the median family income of husband and wife households headed by an individual under 35 years of age—the most important first-time home-buying group—was just $4,700. The median-priced new home on the market that year sold for $16,739. By putting a 25% downpayment on that house and limiting

---

* "The Challenge to Homeownership in the 1980s," U.S. League of Savings Institutions, Chicago

CHART 1
HOMEOWNERSHIP, 1955-1983



Source: Bureau of the Census

monthly mortgage principal and interest payments to the standard 25% of income, the median-income family could readily qualify for the typical house offered by builders in 1956. In fact, the family could have qualified for a house $1,137 *more* expensive and still stayed within standard budget norms.

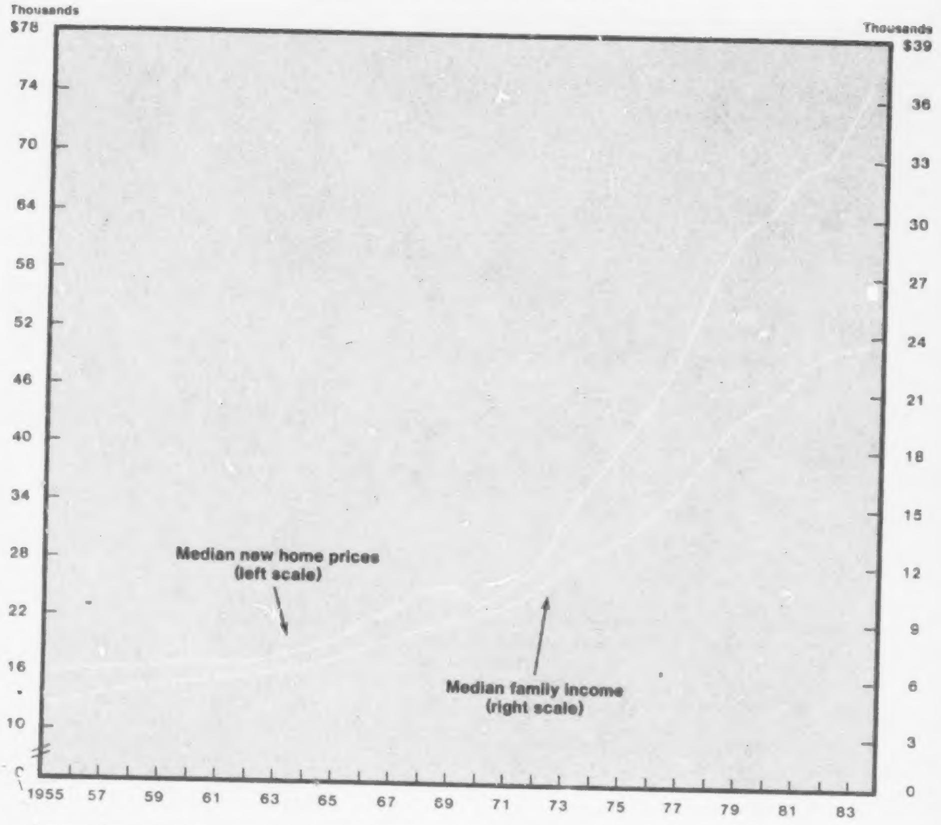
By 1960, homeownership was even more affordable. Although median new home prices had risen 5% ($800) to $17,500 during the four years, and mortgage interest rates had risen to 6% from 5.5% in 1956, median family incomes had risen *14.4%* to nearly $5,400. As a result, the median-income family could afford not only the median-priced new home produced that year, but a house well beyond it in size and amenities. The family could comfortably finance and move into a $22,100 home—26% more costly than the median for 1960.

As Chart 3 reveals, a broad base of affordability continued throughout the 1960s. Not surprisingly, the period of the 1950s and 1960s also registered substantial gains in the national rate of homeownership. These were indeed the golden years of housing affordability, and millions of first-time buyers made the most of this opportunity.

The decade of the 1970s, by contrast, brought the first jolting aberrations to homeownership opportunity. Family incomes rose steadily—roughly doubling between 1970 and 1980—but they couldn't match the pace of housing prices, which nearly *tripled* during the same 10 years.

Inflation, which had been a negligible factor in the housing market in prior years, became a dominant, distorting force by 1977-1978. Interest rates hit double digits for the first time in 1978. Median home prices ballooned by $18,000 in the span of just 24 months in 1977 and 1978.

CHART 2
HOME PRICES AND INCOMES

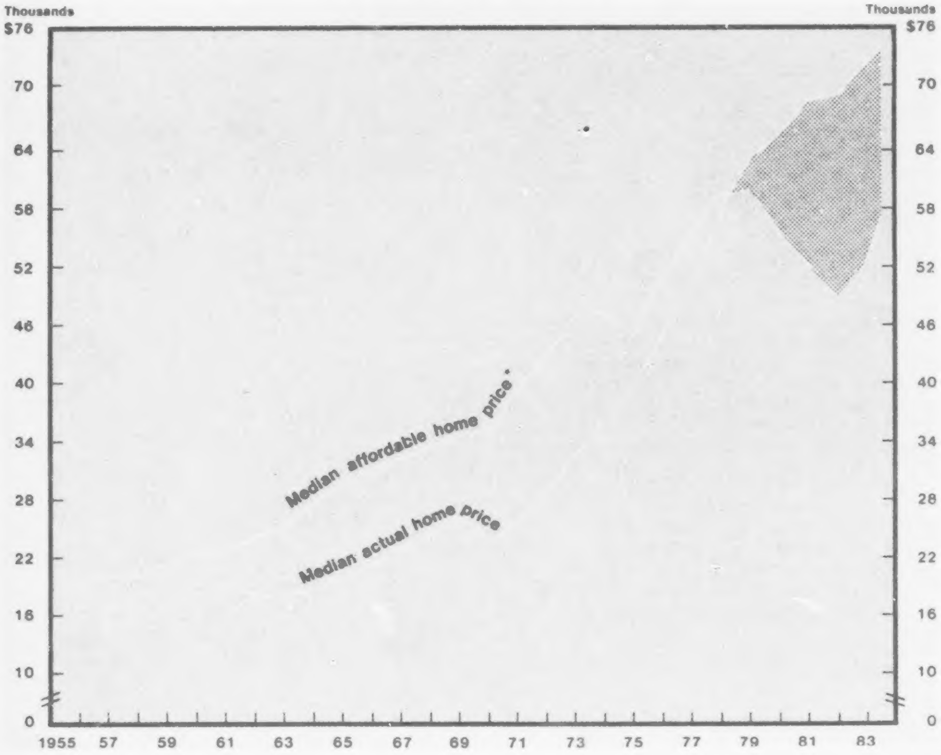


Sources: U.S. Department of Commerce and U.S. League of Savings Institutions

By 1979, the traditional equation of affordability fell apart. For the first time since 1953, the median-income household could not qualify to buy the median-priced new home at the interest rates and terms available in the conventional marketplace.

The typical family of 1979 could afford to finance a home costing less than $59,000, but median home prices had risen to $63,000, or $4,000 beyond the consumers' reach. In 1980, the affordability gap grew to nearly $11,000. By 1981 it exceeded $19,000.

CHART 3
THE AFFORDABILITY GAP



*Affordable home price based on 25% downpayment and monthly payment equal to 25% of monthly median income for husband/wife families with householder under 35 years of age.

Sources: U.S. Department of Commerce and U.S. League of Savings Institutions

Since then—with modest declines in mortgage rates plus a slowdown in the rate of housing price increases—the gap has narrowed somewhat. Yet as of July 1983, the median-income household still faced a $16,250 deficit between the cost of the house it could afford to buy and the median-cost new house the marketplace offered.

That huge gap—which threatens to widen further in the second half of 1983 as interest rates rise from 12.5% to 14%—is the reason why American homeownership is on the decline.

The old affordability equation, which housed two generations of American buyers, is nowhere near returning to positive in the 1980s.

Even taking into account the facts that more families are willing to commit higher percentages of income to housing and that lenders have increased the rule-of-thumb for mortgage underwriting from the old 25% standard, the affordability gap remains huge. Moreover, as the pace of inflation has dampened in recent months, it is likely that the rationale for "stretching" beyond the 25% standard will weaken somewhat—leading to even more cause for concern about the seemingly unbridgeable gap.

HOME PRICES AND AFFORDABILITY: POTENTIALS AND PROBLEMS

Without a significant moderation in the rate of increase in the selling prices of houses, the prospects for a narrowing of the affordability gap during the balance of the 1980s are bleak.

How is the American economy doing in that regard thus far in the decade? Is there any real possibility that we can keep the key components of housing prices—land and labor costs, the square footage of homes sold and the costs of building materials—under control?

The task force's research suggests a mixed record to date, and a number of needed actions to hold down the annual surge in home prices.

Here is a brief overview of the price patterns that will affect housing for the coming several years.

HOUSING SIZE

Clearly one of the key contributing factors to the sharp escalation in prices during the 1970s was the steady increase in the physical dimensions of houses offered for sale.

As Table 1 shows, the average single-family home sold in the United States hit 1,760 square feet in 1979—nearly twice the size of the modest 1,000 and 1,100 square foot subdivision dwellings that fueled the housing boom for first-time purchasers of the 1950s and 1960s.

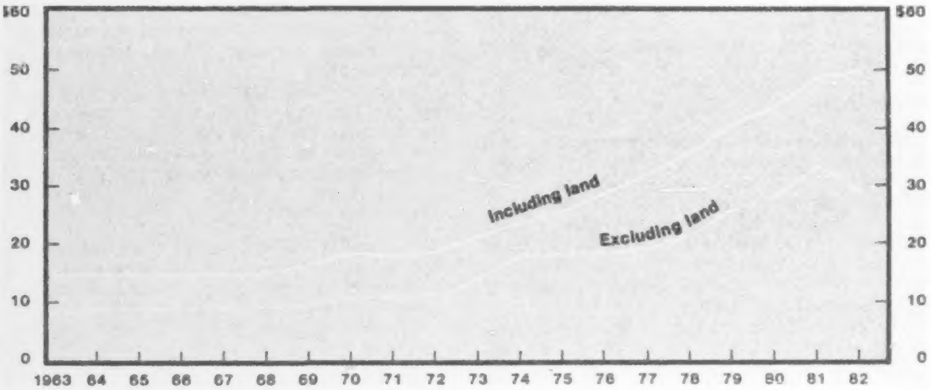
The first three years of the 1980s, by contrast with the 1970s, have witnessed a decrease in the square footage of houses on the market. The average new home sold in 1981 had 1,720 square feet. The average by the end of 1982 was 1,690 square feet.

TABLE 1
AVERAGE NEW HOME SIZES

Year	Square Feet
1963	1,450
1964	1,470
1965	1,525
1966	1,570
1967	1,610
1968	1,665
1969	1,640
1970	1,510
1971	1,575
1972	1,590
1973	1,660
1974	1,670
1975	1,660
1976	1,710
1977	1,720
1978	1,755
1979	1,760
1980	1,740
1981	1,720
1982	1,690

Sources: Bureau of the Census and the Department of Housing and Urban Development

CHART 4
AVERAGE COST PER SQUARE FOOT OF NEW HOUSING UNITS



Source: U.S. League of Savings Institutions

This downsizing trend reflects home builders' shifts to higher density townhouse and condominium units, along with more efforts to achieve space-efficient floor plan designs.

The decline in size, nonetheless, should be kept in perspective. The average new home on the market today still is nearly one-fifth larger than the average sold in 1963, despite the fact that American households are smaller than they were 20 years ago.

Does the American consumer of the 1980s—particularly the first-time purchaser and the empty-nesters who represent such important segments of the market—require units as large as builders continue to offer? In view of the size of the affordability gap, the urge to cut square footage even further during the 1980s is inescapable.

CONSTRUCTION AND LAND COSTS

As Chart 4 shows, commonly held assumptions that the costs of housing per square foot have moderated during the recession years of the 1980s prove to be incorrect. The selling cost per square foot of houses (including land) has continued to rise—despite tough economic times—and probably exceeds $50 per square foot today. That figure is up from just $14.91 in 1963, $25.66 as recently as 1975 and $40.80 in 1979.

What has begun to moderate somewhat is the average cost per square foot of construction. After shooting up to a peak of $33.14 per square foot in 1981, construction costs—minus the cost of land—declined to $29.00 per foot in 1982.

In other words, the bottom line to a consumer—total cost per square foot of a new home—is still on the rise, even though the construction component of that cost has moderated and the rate of inflation is on the decline.

Put in dollar terms, every 100 square feet of extra space added to the size of a home and associated land in 1983 adds $5,000 to the average price of a new home.

At a time when the cost of money shows no sign of decreasing, the benefits of keeping a tight lid on construction costs, labor costs and the land associated with each unit are compelling.

Cutting 200 square feet off the size of the average new house today can save $10,000 from the bottom-line cost to the consumer. That action alone would reduce the affordability gap by more than half.

LABOR COSTS

One of the most important components of the cost of a home is construction labor. The cost of labor for housing is second only to that for mining among major sectors of the U.S. economy. Moreover, the productivity of labor in residential construction—output per man hour—has dropped from what it had been in the 1960s, while earnings per hour have risen sharply—unlike the pattern in most sectors of the economy.

The cyclical boom and bust swings that housing faces have taken their toll on productivity. Any industry in which large numbers of producers periodically dismantle their businesses because of government economic policies—as occurred in 1974-1975 and again in 1980-1982 in home building—cannot hope to be cost-efficient. Home builders and construction labor have been at the cutting edge of major movements in the economy in the past 15 years, not by accident but by design of economic policymakers. Home building has been used to "turn on" the economy—such as in 1969-1970, 1975-1976, 1982—and to turn it off. The housing industry has been the first to experience recession in the downswings of the economic cycle.

Playing such an economic role is exceptionally costly and wasteful, with pernicious, long-lasting effects on affordability.

The reason why extremely cyclical behavior results in excessive home price inflation centers on the so-called "rebound effect." Producers of housing supplies, whether insulation, refrigerators or door knobs, for example, have learned to protect themselves from cyclical swings by making sure they don't get stuck with large inventories, which are expensive to warehouse. They produce for the bottom of the cycle rather than the middle or top. This results in post-recession shortages of supplies just when demand is strengthening. Builders with half-finished homes waiting for delivery of key supplies are willing to pay top dollar, and prices soar.

Land and labor costs are similarly driven up as the cycle rebounds suddenly after leveling off in recessionary times. Delays in obtaining building permits when building departments have cut back on staff add further to "rebound" costs.

REGULATORY COSTS

Throughout its study, the task force has been impressed with the potential impact on home prices associated with reductions in nonessential local government regulatory burdens.

In communities across the United States, thousands of dollars per unit could be cut from the final selling prices of homes in 1983-1984 by simply revising local subdivision development standards, moderating zoning code requirements that limit high densities and that cause bigger units, easing building standards in ways that reduce costs but not building quality, revising local construction codes to permit use of new technologies and materials, eliminating exclusionary zoning, initiating permitting processes that are fair to both price and procedures, and adopting "sensible growth" ordinances that balance legitimate environmental concerns with the needs of people for housing.

Consider the following example of what we believe is possible in every community. The case involves a residential duplex and triplex project built and sold in 1982 in Lincoln, Neb., under a demonstration project cosponsored by the U.S. Department of Housing and Urban Development, the city of Lincoln and the National Association of Home Builders Research Foundation.

The townhouses contained units with 844 and 880 square feet of finished living space, plus unfinished basements of approximately 500 square feet apiece. Price ranges were $39,950 to $46,000.

Under the demonstration program, the builder-developers were allowed four major areas of relaxation of the city's usual standards and procedures. The city:

Modified its zoning ordinances for the townhouses to permit 52 units on a site that otherwise would have been limited to 32.

Revised its standards for paving, sidewalks, flowlines and street lights to permit newer technology in paving and to allow exterior lighting to be house-mounted rather than pole-mounted. Sidewalks on only one side of the street were required, rather than both.

Permitted the units to have unfinished basements, rather than finished.

Cut the processing time for permits, approvals and inspections on the units by eliminating bureaucratic red-tape.

Here is a summary of what these and other changes saved in terms of selling prices of the finished units in Lincoln:

TABLE 2
COST SAVINGS IN LINCOLN HOUSING UNITS

Major Cost Category	Cost Savings Per Unit
Raw land	$ 480.00
Land development	4,474.01
Direct construction	3,563.11
Indirect, overhead, financing	485.00
Reduction in processing time	1,116.00
Total	$ 10,118.12

It is true that a portion of the $10,000 cost reduction resulted from changes in standards that one could argue constitute reductions in quality, such as fewer sidewalks, higher density in living units and unfinished space rather than finished. (Some buyers, of course, prefer to leave space unfinished until they know better their family needs and have the time and money to finish it, and in these cases, quality has not suffered.) These factors account for 40% of the net savings per unit, or about $4,200.

The balance of the savings, however—roughly $5,900 per unit—arose from changes in codes and processing standards that simply allowed more efficient building materials and construction techniques to be used. They *enhanced* quality in most instances, while allowing a decrease in the finished cost.

The task force submits that *both* types of cost-reducing approaches are needed in communities across the country: slight diminutions in perceived "quality" (such as higher densities) *plus* reductions in red-tape and antiquated codes, *a la* Lincoln, Neb.

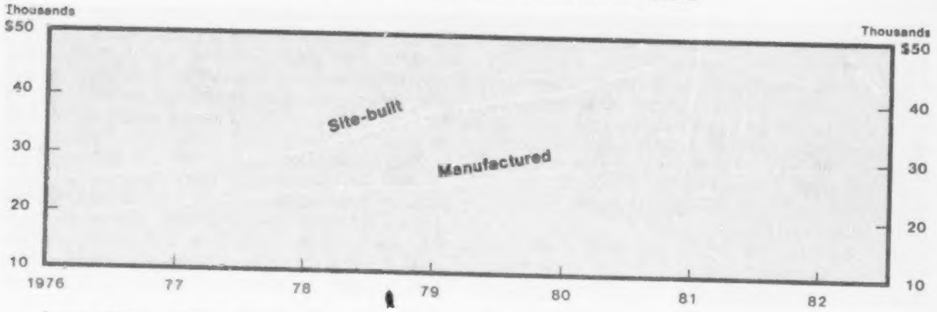
Picture what the percentage reductions in this project alone—approximately 25% savings to the home buyer—could mean for affordability if duplicated in every city and county.

MANUFACTURED HOUSING: HIGH-TECH OPTION FOR THE 1980s

One of the most important cost-cutting advances for housing has been in process for years: the evolution of the mobile home industry into a producer of high-quality, nonmobile manufactured housing. Whether we as a nation learn to accept this evolution and make the most of it will directly affect our success in closing the affordability gap in the coming five to 10 years.

The manufactured housing sector, it is fair to say, is the most cost-efficient force in American home building today. Chart 5 depicts this.

CHART 5
CONSTRUCTION COST FOR 1,500 SQUARE FEET SITE-BUILT VS. MANUFACTURED HOMES



Sources: U.S. League of Savings Institutions and Manufactured Housing Institute

The construction costs for comparable 1,500 square foot units are 34% lower using manufactured housing, factory-built techniques rather than site-built, traditional approaches. That works out to a $14,670 per unit differential in the final price of a home to the consumer. Labor costs of manufactured units are 32% lower than average hourly wages in conventional residential construction.

With such obvious cost advantages, why hasn't the manufactured housing sector experienced more rapid growth? (See Chart 6.) One reason is local zoning and building codes that treat manufactured housing as an outcast—the stereotyped mobile home "tin can" of the 1950s. Another reason is the negative public image of mobile homes and their manufacturers. Ironically, thanks to recent federal safety and inspection oversight, workmanship in manufactured units often is equal or superior to stick-built new and rehabilitated units.

Overcoming negative public conceptions of manufactured housing is an educational challenge. Public acceptance can be fostered by local governments, by mortgage lenders and by major home builders—many of whom themselves have acquired or are creating manufactured housing firms or divisions.

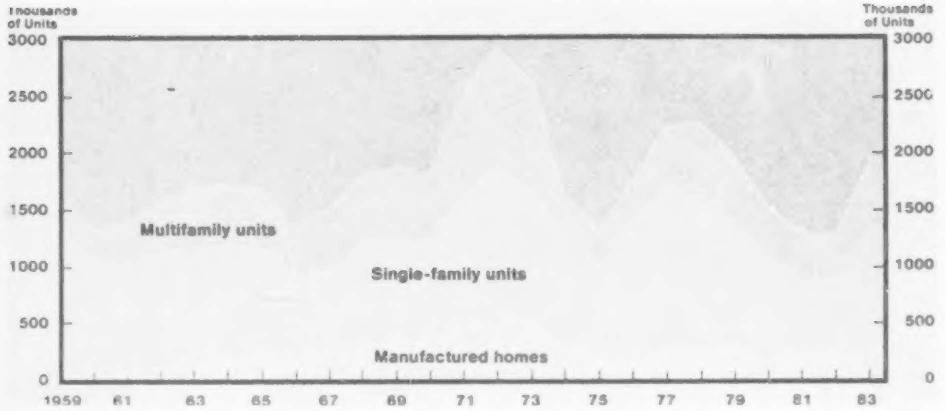
We are not advocating manufactured housing as the solution for everyone. Nor are we suggesting that because of its low cost, manufactured housing be aimed at homeownership for the poor.

To the contrary: We believe manufactured housing has potential market appeal for a wide range of income groups, particularly for first-time buyers and retirees. We advocate that manufactured housing be allowed to compete directly with conventional housing. Remove the zoning and regulatory barriers, we believe, and more developers will shift to manufactured housing products. And because many manufactured homes already are virtually indistinguishable from conventional units, wider consumer acceptance will follow.

MORTGAGE CREDIT AND AFFORDABILITY

The connection between the supply and cost of credit and the affordability of housing to the consumer is powerful and obvious.

CHART 6
TOTAL HOUSING PRODUCTION



Sources: Bureau of the Census and National Association of Realtors

Yet in its research over the past half year, the Homeownership Task Force has been struck by the widespread misunderstandings that exist about the causes of high mortgage rates, and the effects on affordability of alternative types of mortgage vehicles.

Future discussions in the task force's series of papers will examine the structure of the American mortgage finance system in more detail. Regarding the specific issue of housing affordability, however, we wish to make several points here.

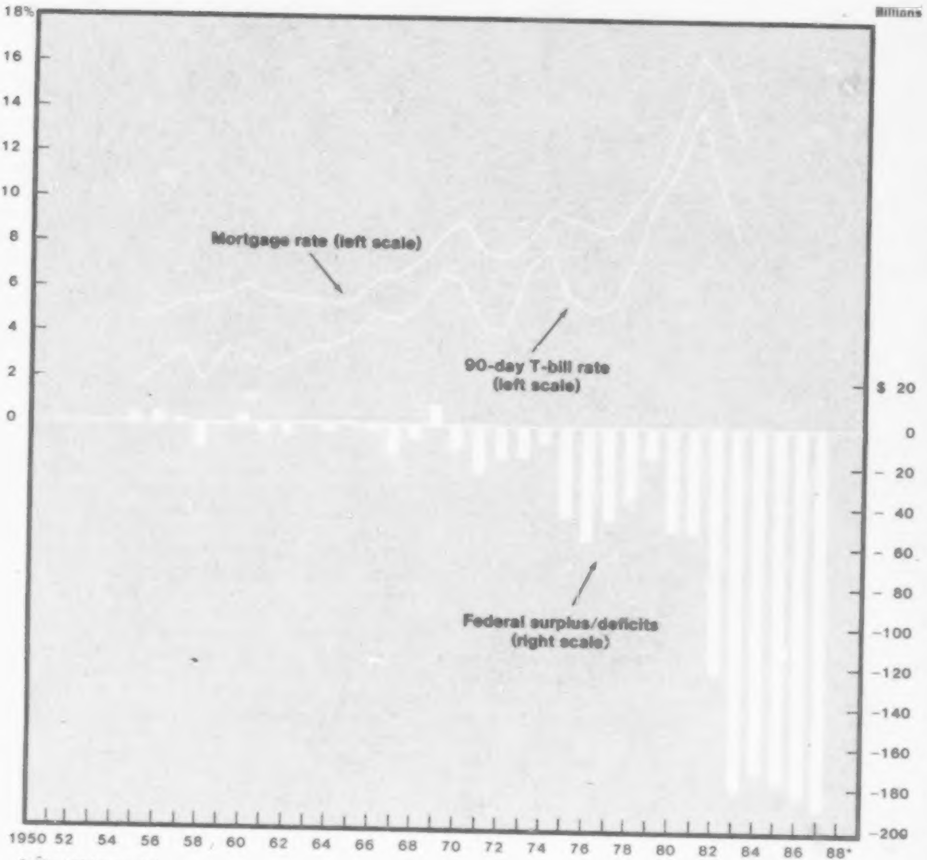
The high mortgage rates that began seriously to affect affordability in the 1970s were the products of a major shift in national economic policy that triggered severe instability in the flow of mortgage credit. The United States moved from an economy dominated by a cyclically balanced budget to one of chronic budget imbalance. Monetary policy—with its sharp, immediate effects on interest rates—has become the principal lever of control on economic behavior. As long as fiscal policy remains in a secondary role, and federal deficits spill more red ink from year to year, American home buyers and builders will pay the price via historically high interest rates.

Chart 7 graphically depicts the course of this shift in economic policy and its direct impact on the loan rates paid by home buyers. During the 1950s and 1960s, the federal budget was geared to the concept of cyclical balance. When unemployment rose above 3%—the so-called "full employment" level—the federal budget was designed to go into temporary deficit through higher spending. It would shore up demand, minimize the depth of the recession and induce recovery back to the full employment level.

On the other hand, when the economy grew too fast and unemployment fell below 3%, the policy was designed to produce federal surpluses, through either spending cuts or revenue increases. This would take the wind out of demand, slow down growth to manageable levels and eventually restore the system to its full employment equilibrium level.

Federal monetary strategy throughout this period was closely intertwined with fiscal policy. Its role was to keep the financial system as liquid as possible, and to maintain interest rates at or near their "bottom stop."

CHART 7
INTEREST RATES AND FEDERAL DEFICITS



*1984-1987 projected

Source: Department of Commerce

The cyclical balance concept served the nation well and was a key to the growth of homeownership in the 1950s and 1960s.

Cyclical balance, however, became one of the early casualties of the Vietnam War and has never fully recovered. Federal spending for domestic and military programs created a string of deficits beginning in the mid-1960s that only once has been broken (in 1969). Rather than taking the tough, balanced approach of raising taxes to pay for higher spending, presidents and congresses from the late 1960s onward have allowed their high spending to produce progressively higher deficits.

Housing and mortgage lending—tied irretrievably to conditions in the capital markets—have been among the principal victims of this policy shift. Housing, it should be emphasized, has been a victim of great convenience because it reacts so sharply and quickly to even subtle monetary changes.

A mortgage rate rise or decline of just one percentage point in 1982, for instance, pushed out or brought in between 150,000 and 200,000 new home buyers to the marketplace.

That sort of instant mass responsiveness has been exceptionally valuable to policymakers at the Federal Reserve and the Treasury Department, but it has also been very damaging to mortgage lenders, home buyers and builders for nearly two decades. In large part, it has also brought us to the difficult state faced by home buyers today. Mortgage rates of 14% are part of an effort to slow the pace of a recovery the Fed believes has progressed too fast.

Housing again functions as the brake—forcing home builders to cancel plans for new construction this fall, and buyers to scatter from the marketplace. The federal government, meanwhile, stands first in line for capital to finance its own ballooning $200 billion deficit.

The regulatory framework imposed on the nation's principal mortgage lenders has been—and could be in the future—a key contributing factor to instability in mortgage credit availability.

Savings rate controls helped make savings institutions the handmaidens of the economic policy of the 1970s. The combination of heavy financial institution regulation, growth of nonregulated financial entities, inflation and tight monetary policy exposed the traditional mortgage lenders to grievous damage during periods of disintermediation. When it was time for housing to cool down inflation, savings institutions' large, vulnerable pools of rate-sensitive funds were the first, easy target. The instability of credit this strategy created for housing production and lending contributed directly to higher prices for the consumer.

We are now, of course, in the new world of deregulation, growing out of 1980 and 1982 congressional actions. Lenders have a wide range of investment options and powers—most notably the capacity to better balance their assets and liabilities—that hold out the promise of improvement over the conditions they operated under during the 1960s and 1970s.

The Homeownership Task Force is concerned, however, that deregulation, with all its apparent advances, could ultimately bring about a return to instability for the finance of housing.

Deregulation, may, as intended, attract to home mortgage lending some investors that traditionally have directed their energies elsewhere. That, we believe, would be a positive development for homeownership. Whether those same investors will remain steadily in the market for housing for the long term—or whether they will sharply scale back when other investments appear more attractive—is debatable.

If indeed they follow their historical patterns—and withdraw from mortgage lending periodically to follow shifts in market opportunity—we believe deregulation could impose an enormous cost upon housing, not cut costs.

Table 3 summarizes how reliable various sources of mortgage credit have been in the past. The data are based on annual percentage changes in the market share of the total flow of funds into home mortgages of each type of institution over the 1960-1981 period. The coefficient of variation indicates how steadily institutions have maintained their stake in home loans. The smaller the deviation, the more steady the investment. The larger the variation, the less reliable the commitment of funds by the institution to housing.

The steadiest commitment to housing, the data demonstrate, has been from savings institutions. For others, home mortgage lending has been a sometime thing. What concerns us about the checkered record of some other lenders is that deregulation may open the door for them to acquire growing shares of the home mortgage market in the "up" cycle for housing and to abandon it on the downswing.

Some of these institutions' defense of the fixed rate, long-term mortgage when rates were at 12% to 12.5%, for example, begs the question of how many such loans they'll write at 14% and 14.5%. Will their ability to "access the capital markets" be as strong when the chips are down? Are they, indeed, all-season home mortgage lenders, as savings institutions always have been and—by the available evidence—plan to remain? If not, then deregulation will not have served homeownership well.

TABLE 3
COEFFICIENTS OF VARIATION IN MORTGAGE LENDING

Institution	Annual Percentage Change
Savings associations	5.8%
Government agencies and secondary market	9.0
Mutual savings banks	18.1
Commercial banks	28.1
Life insurance companies	36.3
Others (REITs, uninsured pension funds, individuals, etc.)	38.3

Affordability of housing would be enhanced if the mortgage lending vehicles best suited to consumers' and lenders' needs achieve dominance in the marketplace. The single most cost-effective vehicle is the adjustable rate loan. The single worst vehicle for housing affordability is the fixed rate loan.

If the adjustable loan does achieve dominance and the fixed rate loan fades to secondary importance, a good deal of the cyclicality of housing markets would be evened out. As it was, with the fixed rate loan dominant, buyers would rush into the market—or try to—when rates were low and rush out when rates were high. That volatility of demand and the lender's need to include an inflation "premium" in the fixed loan rate contributed to the affordability problem.

The primary benefit of the new flexible loans, from the standpoint of families on the edge of the affordability gap, is the fact that adjustable loans allow more borrowers to qualify because the initial loan rate is typically much lower than for a fixed rate, long-term loan.

Housing affordability, as we have seen, is the product of an equation that spans time. Affordability is an issue affecting the entire housing system over time. When that system is forced to use a lending vehicle that entails a high, built-in inflation risk premium, affordability suffers because the cost of money is unnecessarily high.

Fixed rate home mortgages—though beloved by millions of consumers who obtained them during the 1970s—were in fact a key cause for the housing depression of 1980-1982. Had savings institutions been permitted to deal with the emerging inflation of the 1970s by issuing adjustable rate mortgages that better allocated the risk of future rate rises, consumers and builders would not have experienced as deep a "bust" as they have during the past several years. Mortgage rates might have been higher earlier in the 1970s, but housing prices and mortgage interest costs would not have rocketed so high during the latter years of the 1970s.

A systemic argument on behalf of adjustable rate loans, however, is not the only reason why they are important to affordability. Over a typical holding period for the average consumer, the adjustable rate mortgage should cost less than the fixed rate loan.

Most consumers (or economists, for that matter) cannot accurately select the "low point" of interest rates during a seven- to 10-year period and time their home purchases to coincide with them. Getting the "right" fixed rate loan, in other words, is a matter of luck or guesswork.

The new breed of adjustable rate loans, by contrast, requires no such roulette. Not only are they usually priced significantly below the going rate for fixed rate loans, but they also contain protections for the consumer against precipitous rises in payments during the term of the mortgage. If rates fall—as they did last August—so do payments on adjustable loans.

These new loan types—supported actively by savings institutions, the Federal National Mortgage Association and more recently the Federal Home Loan Mortgage Corporation—should be the foundation of affordable mortgage lending during the 1980s. They make sense for the consumer, and they represent a major step for savings institutions toward the cost-efficient goal of "closed-gap" lending. Only by matching the terms of their liabilities with the terms of their assets—the closed-gap concept in a nutshell—will lenders be able to pass on to the consumer the full savings from deregulation.

AFFORDABILITY FOR THE MOST VULNERABLE GROUPS: LOW- AND MODERATE-INCOME BUYERS

Throughout its research, the task force has been struck by the impact of deteriorating affordability on the income groups at the lower margin of the homeownership marketplace.

Families at the edge of the official U.S. poverty line in 1975 could nonetheless afford to buy a low-priced home—provided they would devote the same percentage of their incomes to ownership housing expenses as they typically would to rent (about 31%).

Today, by contrast, such opportunities at the margins are largely gone, even with a higher percentage of income devoted to mortgage payments. Table 4 illustrates the change.

The poverty line family of four in 1975 had a far wider potential range of existing houses available to it, on a national basis. With an income of between $5,000 and $7,000, it could afford a home of between $14,384 and $20,138 by taking out a 90% mortgage at 9%. *On a national basis, better than one out of eight of all the existing resale homes that year were priced within the affordability range of this family.*

TABLE 4
AFFORDABILITY AND AVAILABILITY

1975

Poverty line: $5,500
% of income devoted to mortgage payment: 25%
% of households: 21.1%

Income	Affordable Home Price	Percent of Existing Homes in Affordability Range
$5,000	$14,384	Less than $20,000: 13.3%
6,000	17,261	$20,000-$30,000: 23.9%
7,000	20,138	

1982

Poverty line: $9,860
% of income devoted to mortgage payment: 28%
% of households: 11.5%

Income	Affordable Home Price	Percent of Existing Homes in Affordability Range
$ 7,000	$16,405	Less than $20,000: 2.9%
8,000	18,750	$20,000-$30,000: 4.6%
9,000	21,093	
10,000	23,437	

Sources: U.S. Department of Commerce, Bureau of the Census, National Association of Realtors

The poverty line family of 1982 had a sharply constricted set of choices. Only slightly more than 3% of all existing resale houses in the U.S. were under the $23,000 affordable price of the poverty line family of four, with an income of $9,860.

The decline in affordability for the poor and near-poor during the past eight years has been more dramatic than the drop for other groups. On purely societal grounds, that should be an alarm bell. The near-poor and poor—the young renters, the minority and immigrant households, the large families who can't fit into rental housing—traditionally have clung to the hope of one day buying a home and joining the ranks of American property owners. Buying a home has been an important motivating force to keep trying, to keep working, to have faith in the system.

There is another important point to be made about affordable homeownership. For many families, the very factor of owning rather than renting contributes significantly to the family's nonhousing-related standard of living.

America's elderly families who have poverty-level retirement incomes ($7,000 to $10,000) have substantially more income to devote to their basic human needs if they own their homes. Indeed, the 1981 Annual Housing Survey of the Bureau of the Census shows that households with incomes at or slightly below the poverty line spend 36% of their income for shelter if they rent and only 18% if they own and occupy their homes free of mortgage debt. The published census data do not reveal the proportion of these homeowners who are over 65, but other census data show that 59% of all homeowning households in this income group are 65 and older. U.S. League survey data indicate that 73% of homeowners over age 65 own their homes free and clear.

This benefit to retired Americans is a legacy of the traditional priority accorded to homeownership in this country.

If the 1980s and future decades are going to mean a progressive closing of that door, we may end up losing more than homeownership. We may rend the fabric of our social and economic system itself—leaving long-term damage not readily repaired.

By raising this issue, the task force does not mean the nation requires new forms of subsidy to put low-income families into homes. We do, however, favor sensible approaches designed to reorient current expenditures to better help groups that need help most.

A significant example of what we advocate is pending on Capitol Hill. The Mortgage Credit Certificate (MCC) embodied in the "First-time Home Buyers Assistance Act of 1983" would allow state and local governments to exchange all or part of their tax-exempt mortgage revenue bond (MRB) issuing authority for a new, more efficient program of tax credits.

Instead of reducing monthly payments on a mortgage through interest-rate reductions, as MRB programs do, MCCs would reduce monthly payments for eligible first-time home buyers through an income tax credit of 10% to 50% of their annual mortgage interest payment. The amount of the credit would be set by the MCC-issuing agency based on beneficiary incomes and needs. Low-income families who have little or no tax liability would receive payment of their credits from the U.S. government.

The MCC concept is one designed to assist more beneficiaries, more flexibly and at less cost than do current MRB programs. Recent studies of the proposal indicate that up to 14% more beneficiaries could be served as well with MCCs as with MRB programs. Depending on the economic needs of families, MCCs could also be designed to provide deeper subsidies than MRBs. This flexibility would allow subsidy programs to be tailored to families' incomes and shelter needs. Additionally, the General Accounting Office of the U.S. government estimates that an MCC program could save the U.S. Treasury 20% to 40% of the cost of equivalent amounts of MRB financing. The GAO estimates that had the $10 billion in MRBs issued in 1981-1982 been done through MCCs, the savings to the government could have been as much as $1.6 billion over a 12-year period.

By eliminating the inequities and inefficiencies of MRB financing, MCCs could bring affordable housing within reach for tens of thousands more low- and moderate-income buyers than is possible today.

Homeownership Task Force

Donald F. Wall
president
Michigan Savings and Loan League
Lansing, Mich.

Theo H. Pitt Jr.
president
Home Savings
Rocky Mount, N.C.

Kenneth J. Abt
president
First Federal Savings
Middletown, N.Y.

Charles D. Acton
chairman and president
Heritage Savings
Duncanville, Tex.

David S. Barrows
president
Oregon Savings League
Portland, Ore.

Ben H. Bond Jr.
Ben Bond Associates
Honolulu, Hawaii

E. L. Byington Jr.
president
Charter Federal Savings
Bristol, Va.

Kent Dixon
chairman
Northeast Savings
Schenechtedy, N.Y.

Gary H. Driggs
president
Western Savings
Phoenix, Ariz.

Peter J. Farmer
president
Horizon Financial, F.A.
Southampton, Pa.

Anthony M. Frank
chairman and president
First Nationwide Savings
San Francisco, Calif.

Raymond T. Gusnard
president
Roosevelt Federal Savings
Chesterfield, Mo.

Jock Hewitt
president
Provident Federal Savings
Boise, Idaho

H. Dewayne Kreager
chairman
Pacific First Federal Savings
Tacoma, Wash.

W.W. McAllister III
president
San Antonio Savings
San Antonio, Tex.

Joe C. Morris
president
Columbia Savings
Emporia, Kan.

Donald F. Morton
chairman and president
Arlington Federal Savings
Arlington Heights, Ill.

William E. Nodine
chairman
Pioneer Federal Savings
Clearwater, Fla.

Robert O'Brien Jr.
president
Carteret Savings
Newark, N.J.

William Popejoy
chief executive officer and president
Financial Federation
Culver City, Calif.

William G. Schuett
president
Security Savings
Milwaukee, Wis.

Joseph C. Scully
president
St. Paul Federal Savings
Chicago, Ill.

Randall B. Tetro
president
Norwood Co-operative Bank
Norwood, Mass.

Marvin Halstead
president
Equitable Federal Savings
Fremont, Neb.

Leonard Shane
chairman and president
Mercury Savings
Huntington Beach, Calif.

Paul Prior
chairman and president
Henry County Savings
New Castle, Ind.

Jay Janis
Los Angeles, Calif.

James W. Christian
vice president, chief economist and
director, Economics Department
Chicago, Ill.

Rita I. Fair
vice president, Regulatory Operations
Washington, D.C.

Mr. **Nowak**. Thank you very much. We are looking at total credit. Certainly the whole market affects small business perhaps greater than any other, and if there's movement in that market, it has a tremendous ripple effect right across every type of consumer good that is purchased for the home. You are talking about the rugs and the furniture, and if there is enough confidence and dollars available for that first purchase, and then that ripple effect seems to just move across the economy and pick it up.

You know, we've been in a period here where we were down to 67 or 68 percent industrial capacity, and finally that has come up to 78 percent. We have seen some movement at least in the early spring and early summer. When rates got down a little bit, we saw some movement in this whole market happen very quickly, but then as soon as that rate went up another point and a half or two points, it seemed to stop dead in its tracks. I think the consumer spending is going to be in a very important phase. In looking at the Chemical Bank survey, one of the very pertinent questions asked the businesses was what their problems were and how they could get the economy moving, so to speak.

The tightness of that consumer spending was the biggest problem, and if consumers would start spending again, and start to hire and expand and do everything else that a successful small business should do, we could see some progress.

I think it starts with available credit throughout the whole segment of the economy, and this mortgage area is certainly one that is so interest-rate sensitive that if we look at the economy with the rate as it is structured now, are you projecting any great growth in either new housing or repurchased housing in the future?

If we're talking 14, 13½ now for a fixed 30-year rate for 14 percent, if that were to move a point down what kind of an increase could you suggest?

Mr. **Glover**. I would think if the rates could move down even 1 percent it would make a tremendous change. We still have a lot of areas of high unemployment such as Congressman Williams'. We're close neighbors, and have very high unemployment, and we have very little construction or new purchases or refinancing of existing dwellings. However, when the rates dropped down a few months ago, when we got down to a place where in our area, adjustable rate mortgages, we are running anywhere from 11½ to 12 percent and fixed rates 13½ to 14, when those rates dropped down a little bit we saw a tremendous increase in activity. Even with the unemployment, there was a pent-up demand, and I don't think it would take too much of a drop to see a tremendous increase in the housing activity of our country.

Mr. **Nowak**. The cost of money to the banks has risen with deregulation, and one of the problems that has been suggested is how we're going to ratchet this down, if inflation does, in fact, stabilize. Of course, you know, everybody talks about the Federal deficit and the other problems, but taking as a premise that inflation stays at 4 percent, where would you envision the rate to be if this stayed stable at least another year or two?

Mr. **Glover**. I don't think we're going to see mortgage rates drop substantially. I'd like to say that we'd see them down to 10 percent, but I doubt very much if they're going to get much below 11 or

11½ percent, if things stay where they're at right now. The cost of money is continuing to go up, and as you know, most of our savings and loans make our loans based on the cost of funds.

We make our commercial loans based on our cost of funds, not the prime rate also.

Mr. **Nowak**. Well, we talked about this 5¼ count disappearing in a couple years, moving up to 8½ or 9 percent, whatever the case may be. I guess my question is, who is going to be the first bank to advertise a 6-percent deposit rate to start the process ratcheting down, so we can get your cost of money down again? What events are likely to take place to start this ratcheting process down so that you can get 3 points over 7 percent for that 10-percent mortgage rate that will give you the spread.

Mr. **Glover**. OK. Suppose I went back to my office tomorrow, and said the only rate we were going to offer is 7 percent on all of our deposits. Better get out of the way because all the money would be gone the next day.

There's going to be somebody out there after it at a higher rate and the Federal Government, of course, is one of the main competitors for those funds. You mentioned the deficit, and the deficit does have something to do with the cost of funds, because the Government is directly competing for those funds on a continuing basis, which helps keep the interest rate up. As long as we have to compete with that or pay a market interest rate on deposits, there's no way for mortgage rates to come down or consumer loan rates to come down.

I think you'll note in my comments that savings and loans could operate with a 1¾-percent spread which we would love to see again, not 2 or 3 percent; 1¾ would be great.

Mr. **Nowak**. What is the Federal fund right now? Do you know?

Mr. **Glover**. It is in the nines, isn't it?

Mr. **Nowak**. Nine.

Mr. **Glover**. Eight-and-three-quarters.

Mr. **Nowak**. Eight-and-three-quarters now? What would be the effect if that Federal fund rate was dropped down to 7 percent?

Mr. **Glover**. It wouldn't affect us a whole lot because our funds come from other sources, from savings deposits. It would affect the commercial banking industry more.

Mr. **Nowak**. If that rate went down to that proportion, wouldn't they borrow a larger number of percentage of their funds from that source?

Mr. **Glover**. I am really not qualified when it comes to discussion of Federal funds. We invest in them, but I am not an expert by any means on Federal funding.

Mr. **Nowak**. What I was alluding to is perhaps that is the way to start this rationing process if we're ever going to receive it, if there's a lower source of cost of money that is substantial, and you use that to start the whole process down.

Mr. **Glover**. One of the things that happens is that whenever things have been deregulated, we always have a few financial institutions who are willing to go out and pay a much higher interest rate than they can afford to pay, and so consequently everyone seems to think they have to follow suit, but this last deregulation on October 1, that didn't happen anywhere near to the extent that it happened last time.

Mr. Nowak. Your first round, right.

Mr. Glover. Well, the financial institutions used a lot more sense and so it was handled better. The cost is not going to be as prohibitive.

Mr. Nowak. I understand that in some of the bigger money markets, that there was substantial interest in competition even this time around, although for the rest of the country it didn't seem you had anywhere near the impact you had the first time for those funds.

Mr. Glover. That's right.

Mr. Nowak. As I say there's still more to come, and these adjustments will have to be made. Unfortunately, we have a vote on the House floor, and I don't want to hold you up till after that. I'll submit some other questions and call on Mr. Williams.

Mr Williams. First of all I want to welcome you. Mr. Chairman; Conneaut, Ohio, is a great town. [Laughter.]

It's on the shores of Lake Erie and I want to personally thank you for coming, representing northeastern Ohio as well as the role you play nationally.

I guess one of the things that's bothered me for some nearly 5 years now—which is the exact time I've been here—is where are we going? Is everything going to be dependent on what happens here in Washington, what the Government does in order to get this down, or it may be just to add to the chairman's questioning.

Can we really look to the private sector, the financial community to begin to make movement on their own? Are we really caught in a situation where we're going to wait for the Government and we're going to wait for you? Where are we going in your opinion?

Mr. Glover. Personally, and this is not speaking on behalf of the U.S. league things are getting so complex that I don't think anyone is ever going to be able to straighten it out. I think the consolidation of regulatory agencies and financial institutions is a dangerous position to move toward. I think if we get to the place where we lose sight of the private sector in business or we get too much control in one area, whether it be Government, or financial institutions or industry, or whatever, then we're headed for a real serious problem.

I think things are so big and so complex now that it is almost impossible to deal with. I go back to my little town of Conneaut and try to explain what we talk about here, and see the things that go on in Washington. I have a very difficult time with that. Congressman Eckart spent about an hour in my office last week, and we talked about some of these things, and it's a very, very difficult time for financial institutions.

It's also a difficult time for the Government, and there needs to be changes made, because things are so big and so complex. I don't think there's any way to get those units together to solve the problem. I think it's a very, very difficult situation.

Mr. Williams. It's frustrating at least to me because I come from the same area as you. It seems to me at least the 5 years that I've been here that everyone has run to Washington and saying please deregulate us, get Government off our back. It seems once we do that, almost immediately they run back and say please help us, regulate us, and it is frustrating, I know for this Member of Congress to deal with that, and I think we've really maybe, hopefully got to better define what role we're going to play. I guess maybe a combination of trial and error for want of a better term.

Mr. GLOVER. Deregulation may have been too fast as it is in other areas, and it's difficult to adjust to those things. Things come out of the woodwork that nobody anticipated, causing all kinds of difficulties.

Mr. WILLIAMS. How much of a role do you think the variable rate has played in the drop of home ownership, or do you think it has played any role?

Mr. GLOVER. Well, it probably has had some effect on it, but the variable rate mortgage now is coming in at lower rates and a lot of financial institutions are putting ceilings on the amount that a mortgage rate can be increased, and I think people are beginning to accept the fact that they're going to be faced with adjustable rate mortgages as long as they expect adjustable rates on their savings deposits.

Mr. NOWAK. Thank you. Thank you again, and it will be a slow process especially when that rate goes up 2.5 percent in 1 year. On the other side of it, there better be a compensating increase, or you are going to have great difficulty.

I don't know if then that ratches it up again for the next round. I think there's tremendous problems when we look at all of this trying to settle into the economy, and trying to assure that not only small homeownership, because of the ripple effect on small business and small business in general, gets served, and I think we've got to be very careful as we go along. I want to thank you.

I may have some other questions. We're going to keep the record open, and as we fill in all the testimony together, we may generate other inquiries and try to get you to give us that real experience that you're actually having out there interplaying with this whole deregulation process.

I want to thank you, Mr. Glover, for coming, and look forward to additional questions.

Mr. GLOVER. Thank you very much.

Mr. NOWAK. Thank you, sir.

[Whereupon, at 12:45 p.m., the subcommittee adjourned, to reconvene, subject to call of the Chair.]

APPENDIX

PREPARED STATEMENT OF THE NATIONAL SMALL BUSINESS ASSOCIATION

The National Small Business Association [NSB] is a multi-industry trade association representing approximately 50,000 small business firms nationwide.

The almost desperate need for capital which small business has always experienced has been aggravated in the past several years by both the reduced availability and the extremely high cost of borrowed money. The macro-economic conditions which have lead to this unhappy state of affairs are already well-known to you, and we will not belabor that subject. However, some very specific phenomena have occurred which have aggravated the problem of availability of monies for small business in a bad way. This Committee knows the important role that small business plays in the American economy, its great contribution to the GNP, and the fact that it has been the single greatest source of employment and new jobs for decades.

To establish or expand a small business, the availability of a bank service is almost indispensable. The source of these loans for small business is in almost every case the community bank, itself a small business. Regrettably, the flow of deposits to these small business institutions has been seriously impaired. Impaired by an incredible set of circumstances which permit financial institutions that do not call themselves banks to operate across state lines, totally unregulated, offering numerous inducements to take money out of community banks and reduce money available for small business lending.

We are, of course, referring to the "money market funds" operated by brokerage houses and even catalog order houses. The success of this unregulated banking activity is easily measured, with $136.8 billion of funds now in the hands of these private money handlers. No limits on interest, no reserve requirements, no capital requirements, no state or federal examinations, just the free market competition. We support as much open market competition as our social and political and economic structure can allow. However, it is totally incongruous that we intervene through government by regulating for the public good the 15,000 licensed banking institutions in this country while we allow a handful of unlicensed bankers to do as they please. It is a situation that our economy cannot tolerate any longer.

Of course there are no funds available for the housing industry. The monies are in the hands of Merrill Lynch, and other large financial institutions who have deposited the funds either in the major money center banks or bought private or government securities by the tens or hundreds of millions. Why would they want to bother making a $90,000 loan to build a home, it is definitely too much bother. In the meantime, the traditional relationship between inflation and the cost of money is ignored by the marketplace while free competition for the limited number of available dollars takes place.

For years, great importance was attached to the safety provided by the federal insurance of deposits, but a 10 point spread in yields can blind even the most conservative saver to the risks which accompany the "money market funds". For years, the Federal Reserve Board sought to gain an even greater control of the money supply and tried various ways to seduce or force the banking industry to become members of the Federal Reserve System, so that it could have a better control of the money supply. Suddenly, it doesn't seem to be of any concern that $136.8 billion is beyond the reach of the Federal Reserve System. In effect we now have a "loose cannon" rolling around on the deck of our economic ship but no one cares as long as it doesn't roll over them.

We think Congress should care, and must care, because the nation's available loan supply is leaving the community and, therefore, being drawn out of the reach of small business and, unless this trend is reversed, the other problems in our economy, i.e. unemployment, lack of adequate tax revenues and business bankruptcy, cannot be cured. Small business needs small banks, and they in turn need the savers' money.

The second topic which we would like to call to your attention is the devastating anti-small business policy being followed by the Federal Savings and Loan Insurance Corporation [FSLIC]. The plight of our savings institutions must be of great concern to Congress. Most of the savings institutions in this nation are mutually-owned or are community-owned capital savings institutions. The FSLIC has a monumental task on its hands due to the impact of current high interest rates on savings institutions, directed and regulated for years toward long-term low-rate mortgage investments. Naturally, under today's economic conditions, many institutions have lost millions of dollars because of the negative spread caused by the high cost of attracting deposits and the low yield on old investments.

The problem we see is that when the FSLIC is faced with the virtual insolvency of a savings institution they look for a larger institution (which is probably also suffering from the same calamity) to take over and merge the small institution into the larger one. They then proceed to inject capital into the large institution to assist in the merger and to provide fresh reserves. The result is an epidemic of mergers of community savings and loan associations and savings banks into a handful of large institutions, certainly easier to control and regulate but at what a cost to our economy. A devastating blow to small business and our economic welfare.

Recently, several community savings and loan institutions merged with one of the "downtown" giants. One of these institutions was the source of financing for a group of homes and apartment buildings that were built during a period of ten years. There is no way that the branches of the downtown giant are going to be in a position to respond to the local general contractors and builders the way the community institution was able to do. The personal knowledge and trust which comes from a long time association with a community is lost when second and third echelon officers and employees of a major institution become the loan officials which the small business contractor must deal with on his loan request.

If the new policies of this country are to move banking in the direction of Europe, Canada, and many other places in this world, where just a handful of banks serve the entire nation, then we certainly have had a successful start in this direction over the past two years. In Canada, approximately 15 banks serve the entire nation. Perhaps we can be left with 115, but is this concentration of money going to help the most important segment of our economy—small business? There is no way for a giant multi-billion dollar bank to economically respond to the local builder who wants to finance one or two homes or acquire a few lots to inventory before building. The big bank wants to deal with big builders who do projects of hundreds of homes. It is a question of economy of scale.

It would seem to us that the FSLIC could assist community financial institutions that have lost their reserves due to economic conditions, totally beyond their control and not through their own mismanagement, so that they could remain in business, in the same manner that the FSLIC is helping the giants. Apparently, it is sensible to inject tens of millions of dollars into the hands of a giant association but impractical to put one or two million dollars into a community association. Of course, administration is easier when you deal with just a few giants but again at what cost to our economy.

Deregulation in the banking community is a controversial topic. Throughout the entire post-war era, we lived with a regulated banking community, and the expectations of savers were generally satisfied. The person that wished to speculate with major sums of money always had places he could invest for a higher return. "Saving" always had a special safety net surrounding this concept and it was the ready availability of this money and not how much it earned that was the prime concern of the typical saver. Today the regular saver is cheated by the artificial low cap that has been placed on the amount of savings interest that may be paid while, on the other hand, the depositor with a slightly larger sum has become a speculator moving his money, as swiftly as interest periods expire, from one money fund to another to gain an extra quarter or half percent. This combination of a half regulated and half unregulated financial sector has led to chaos. Only the government can print money and set its value. It is a monopoly. It is not a product for competition in the free marketplace because it cannot be grown or manufactured or produced in any way through improved productivity or with better ideas and better management. In other words, it is not in our opinion an item that can be set totally free in the marketplace. The government's obligation of establishing and maintaining the value of currency has recently been somewhat ignored, to say the least. To have our government now walk away and announce that it will leave this area of the economy without guidance, without a traffic policeman, if you will, we believe will bring only greater chaos into the money markets at the expense of small business. We urge this Committee to recommend to Congress that it exercise its powers in a manner that:

(1) Will safeguard the value of our currency.

(2) Will preserve the concept of community savings institutions.

(3) Will cause proper steps to be taken to return the $136.8 billion that has been siphoned into the hands of a few big giants back to the small business savings institutions that can put this money to work with America's small business people.

(4) It will send signals to the Federal Savings and Loan Insurance Corporation, that Congress desires to preserve community savings institutions and opposes the concentration of money into financial super giants.

We sincerely hope our testimony will help this Committee to focus on the problem of small business' relation to small business community savings institutions. The current undermining and destruction of this sector of our economy is frightening in the eyes of many who understand this relationship. We feel confident that the members of this Committee understand. We hope you can convince your fellow Members of Congress.

Thank you for giving us the opportunity to present NSB's view on this important topic.

PREPARED STATEMENT OF GORDON S. MACKLIN, ON BEHALF OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

The National Association of Securities Dealers, Inc. (the "NASD" or the "Association") is pleased to furnish the House Subcommittee on Tax, Access to Equity Capital and Business Opportunities with its views and comments regarding the changing structure of the financial services industry. As the Subcommittee is aware, this subject which has been, and continues to be, of considerable interest to the Association.

In view of the escalating rate of change taking place in our industry, in May 1981, the NASD's Board of Governors established a special committee of industry experts to examine the future structure of the securities industry. The express purpose of the Committee was to analyze and interpret current developments and trends in order to assist the Association and its membership in their anticipation of and preparation for the future. The culmination of the Committee's work was the publication by the NASD of the Committee's observations and findings in a report, dated November 1982.

The Committee was composed of H. Lawrence Parker (Committee Chairman), Managing Director, Morgan Stanley & Co. Incorporated, New York; William B. Madden, President, Schneider, Bernet & Hickman, Inc., Dallas; James J. McCormack, Vice President, Metropolitan Life Insurance Co., New York; L. C. Petersen, President, Kirkpatrick, Pettis, Smith, Polian Inc., Omaha; James W. Ratzlaff, Executive Vice President, Capital Research & Management Co., Los Angeles; Ernest F. Rice, Jr., Chairman, Executive Committee, Blunt Ellis & Loewi Incorporated, Milwaukee; and, John A. Wing, President and Chief Executive Officer, The Chicago Corporation, Chicago.

The Report entitled "The Financial Services Industry of Tomorrow" (the "Report" or the "Study"), documents the changes occurring in the financial services industry, explores many of the reasons for those changes and discusses the possible effect of such changes on the financial services industry of tomorrow. In the course of its Study, the Committee held informal conversations with various prominent people in the securities business and in government whose insights were invaluable to the Committee in formulating its expectations for the future. The individuals who met with the Committee were Secretary of the Treasury Donald T. Regan; Roger W. Mehle, the then Assistant Secretary for Domestic Finance, Department of the Treasury; Stephen M. Ege, Elias & Matz (counsel to several savings and loan associations that subsequently formed a broker-dealer subsidiary); Peter A. Cohen, President and Chief Executive Officer, Shearson/American Express; Andrew J. Melton, Jr., Chairman of the Sears Financial Planning Committee and Chairman of the Board of Dean Witter InterCapital Funds, Dean Witter Reynolds Organization, Inc.; James W. Fuller, Senior Vice President, The Charles Schwab Corporation; Robert P. Rittereiser, Executive Vice President, Merrill Lynch, Pierce, Fenner & Smith Incorporated; Garnett L. Keith, Executive Vice President, The Prudential Insurance Company of America; Thomas E. Holloran, Chairman of the Board and Chief Executive Officer, Inter-Regional Financial Group, Inc.; and, the late James L. Bayless, President, Rauscher Pierce Refsnes, Inc.

The Report was directed to all 4,000 Association members, with the expectation that it would assist those which were in the process of fine-tuning their long-tern business strategies and which did not have the opportunity, as did the Committee, to talk with and question knowledgeable industry leaders and high-ranking government officials about their thoughts concerning the financial services industry of tomorrow.

With the Chairman's permission, we would like to submit a copy of that Report for the record.

For the Subcommittee's information, a brief summary of the salient points discussed in that Report now follows.

Without question, the securities industry has entered an era of significant change—change so profound that it will forever alter many, if not all, of the traditional ways securities firms have conducted their businesses. Each change that takes place seems to trigger still more change with the result being that events of far-reaching importance are occurring at an ever-accelerating rate. What is happening today in our industry is tantamount to a revolution in the way business has been done and the way investors have been served for many, many years. Even the name of the industry is changing from what many consider an outmoded and obsolete term—the "securities industry"—to one which is thought to be more descriptive—the "financial services industry." In response to a changing environment, the very structure and composition of the industry has begun to change.

There are three major categories of change which are most apparent in today's financial services industry—the changing nature of securities industry participants; the explosion of many new and innovative products upon the marketplace; and, the growing use and application of technology by the providers of financial services to speed the flow of information to investors and to accelerate the execution of their transactions. Although these changes have, of course, been evolving over some period of time, they have been gathering momentum in recent years.

In terms of industry participants, perhaps the single most important event to have occurred in recent years took place in March 1981, when Prudential Insurance acquired Bache Halsey Stuart Shields. What emerged has become known as a "financial services conglomerate"—an organization structured to offer one-stop shopping for consumers for such things as securities, insurance, financial planning and many other related services.

Prudential's action was based on its assessment that in the future there will be a growing number of consolidations and a blurring of functional distinctions among financial institutions. Prudential concluded that consumers would seek a simplification in the number and complexity of their financial relationships and the nation was not likely to need the 25,000 to 35,000 banks, thrift institutions, insurance companies, larger securities firms and investment counselors of today competing in tomorrow's world for the very same customers. Other organizations obviously agreed with Prudential's assessment of the future. American Express' acquisition of Shearson Loeb Rhoades, Sears' addition of Dean Witter Reynolds Inc. to its operations, and the acquisitions of other securities firms by many large insurance companies (including Kemper, John Hancock, Penn Mutual and Travelers) is ample indication that the trend toward financial conglomeration is now underway.

As the new financial services conglomerates have begun to emerge, the industry, not unexpectedly, has begun to experience a shrinkage in its network of independent regional firms. In many cases, these regional firms are being acquired by national full-line firms; in fewer numbers, these regional firms are merging with one another. Although there are numerous reasons for these developments, in all instances the need to combat the escalating costs of technology and telecommunications systems and the concommitant need to generate the critical mass required to support such systems are both very important considerations.

Along similar lines, a proliferation of smaller specialty firms, which are carving out special market niches for themselves has also begun. One of the most obvious examples of this is the emergence of the discount brokerage firm. The discount firm, which was born in 1975 with the unfixing of commission rates, has grown in popularity by offering commission rates to its clients which are one-half to three-quarters below those charged by full-line securities firms. Other types of specialty firms rapidly emerging on the scene include the tax shelter or "direct participation" firm and the so-called investment management boutique. Like the regional firms, specialty firms must be able to compete in order to survive in tomorrow's world; by concentrating their energies in limited fields of expertise, they hope to survive on the basis of quality of service and personal delivery of such service.

A fourth factor evident in the changing nature of securities industry participants is the aggressive action being taken by banks and savings and loan associations to gain a foothold in the securities industry. Low yielding loan portfolios, the high deposit costs and the changing environment has persuaded the savings and loan industry that it needs to sell products which are less reliant on interest rates or to sell products which, although they are interest rate related, belong to someone else. While the savings and loan industry is looking at securities activities as a practical vehicle to augment its ability to continue its traditional role, the banking industry appears to be responding to many of the same environmental factors that have caused the securities firm to reshape their plans for the future. Like their securities firm counterparts, the banks are exploring new opportunities, including the concept of the "financial supermarket," and they are developing new products and services in response to what they consider new competitive threats.

Many of the larger banks seeking to establish themselves in the securities industry are doing so via the acquisition or start-up of discount brokerage operations. Among the more significant of these developments are Bank of America's recent acquisition of Charles Schwab; Security Pacific's arrangement with Fidelity Brokerage; Union Planters National Bank's purchase of Brenner Steed and Associates, Inc. (a local Memphis discount broker); and the start-up of discount brokerage operations by such other banks as Citicorp, Chemical Bank, Wells Fargo and Mid-Altantic National Bank, to name but a few.

The second change of significance involves the explosion of a vast array of new and innovative products and integrated financial services upon the marketplace. These newly introduced products include asset management accounts (as they are generically known), money market funds, various kinds of financial instruments as well as options and futures on these instruments, direct participation programs, standardized equity options, floating rate notes, zero coupon bonds, universal life insurance, an expanded assortment of variable contracts, all-savers certificates, real estate securities and precious metals. These and other new and sophisticated products are evolving in order to fill investors needs and to give the providers of financial services a competitive edge in their quest for control over investors' funds. The asset management account is an excellent example illustrative of this point.

The asset management account, originally introduced by Merrill Lynch in 1977, normally provides a consumer with a brokerage margin account, a line of credit, a money market fund and the ability to access both assets and borrowing power by checkwriting privileges or a credit card. The success of this product has spawned an entire second generation of asset management accounts now offered by most of the major securities firms. Even the banking industry has begun to introduce new products which closely resemble asset management accounts. A number of banks too have embarked on a variety of cooperative efforts with their securities industry counterparts to provide the fundamental elements of the typical asset management type account.

The third major change taking place in the securities industry involves the growing acceptance of, and necessity for, sophisticated automated systems. Technological change in and of itself has stimulated many in the financial services industry to reshape and redirect their businesses and it is a foregone conclusion that it will promote even more change in the years ahead—most likely at an ever accelerating rate. Clearly, technology has already begun to tear down the traditional concepts of doing business from fixed locations and the need to have physical proximity to a customer. Many industry leaders see the home computer tied to the providers of financial services as one of the most likely developments of the coming decade.

In order to explain why these changes are taking place, it is necessary to focus on three principal areas—changing government attitudes and policies toward the financial services industry; volatile economic conditions coupled with double-digit inflation and interest rates; and, galloping technology and innovation.

Various legislative initiatives and actions by the bank and securities industry regulatory agencies clearly reflect a change in government attitudes and policies. These changing attitudes and policies manifest themselves most clearly in the current deregulatory climate which exists throughout all levels of government. Efforts by key legislators and regulators to adjust the regulatory framework governing the financial services industry further attest to these changing attitudes.

The effect of double-digit inflation and record high interest rates (which had only begun to ease just prior to publication of the Report) must not be overlooked as a major contributing factor in changing the environment in which today's financial services industry operates. One of the primary effects of volatile economic conditions is that today's consumer of financial services has been forced to become much more sophisticated, more inflation-conscious and more risk sensitive than ever before. This, in turn, has prompted the providers of financial services to produce more imaginative and creative products and to offer a variety of unique services in an attempt to satisfy the consumer's needs.

Technology also plays a major role in contributing to the rapid changes occurring in the industry. Technology is providing the industry with expanded capacity and gives its participants the ability to acquire a competitive edge and the opportunity to control selling costs. To some degree or another, the future providers of financial services will need access to state-of-the-art technology and telecommunications facilities in order to survive. The extent of system needs and their level of sophistication will, or course, vary from firm to firm depending on its nature of business activities and its method of operation.

Having looked at what changes are occurring and why they are happening, a foundation has been established upon which their implications for the future can be assessed. Each of the following perceptions and expectations of probable industry developments were formed by our NASD Committee with the assistance of the many helpful people who met with and shared their valuable insights of the future with the Committee, through the Committee's review of a significant number of related studies, reports, testimony and media accounts of current developments, and through spirited discussion of the future course of the industry among the members of the Committee. From all of this, the following summary sets forth what our Committee believes to be the emerging consensuses as to where the financial services industry of the 1980s may be headed.

The evolutionary change going on in the financial services indutry will not only continue at a rapid pace, but it is also quite likely to accelerate.

Many of the regulatory barriers now separating tomorrow's competitors in the financial services industry are likely to be eliminated.

With the removal of regulatory barriers to competition will come increased business opportunities for those who are quick to recognize them and who know how to compete.

As regulatory barriers begin to crumble, the proper management decisions will have to be made lest firms succumb to the temptation and rush into business activities for which they are ill-prepared and ill-suited.

Until the regulatory barriers to competition disappear, there will be increased interaction and cooperative efforts between the banking industry and securities industry as each seeks to bridge the gaps that it has in the financial services currently provided. Until removed, existing laws and regulations will be pushed to the limit.

The emerging financial services industry will become more competitive and consist of institutions of every type and size. The roots of these organizations will trace back to such diverse industries as securities, banking, insurance, real estate and telecommunications.

The transition to the environment of the future may be less difficult for existing securities firms in that they already operate in a telephone-based, electronic environment as opposed to one which operates mainly on the basis of personal contact.

Large multi-product firms or financial supermarkets which will service virtually every financial need of a customer will co-exist in tomorrow's world with smaller firms serving the unique needs of investors.

By building on its strengths and emphasizing those things which it does well, the independent regional firm will not only survive in the financial services world of the future but it will also continue to attract quality personnel and substantial accounts.

There will be a continuation of the current movement to diversify into both financial and non-financial areas, particularly by larger firms, as efforts are made to minimize the erratic behavior of traditional profit centers.

Tomorrow's provider of financial services, regardless of size, will be required to have state-of-the-art technology and telecommunications facilities to retain and attract clients. The extent of these facilities will vary from firm to firm. Even the smallest of firms, however, will have to provide a basic core of technology-supported services. The need to control systems costs will be a paramount concern to all firms.

Wholesalers of clearing and related services as well as firms in the telecommunications field will step forward to provide a full array of on-line data and market services to smaller firms lacking an in-house capability.

Technology and instant communications will continue to accelerate transaction speed and the flow of information to investors thereby bridging territorial boundaries and creating world markets.

Tomorrow's consumer of financial services will continue to be affected by volatile economic conditions and, as such, become more knowledgeable about his needs, have a better understanding of the operation of markets, be more sensitive to inflation and interest rate movements, and be more demanding in terms of prices he pays for the services he receives.

Marketplace participants will take aggressive action to develop multiple relationships with clients to satisfy customer needs and to deal with the lack of consumer loyalty to a single institution. Also, firms will seek to attract clients at an earlier age, even before they have investable funds at their disposal, in order to develop ongoing relationships with potential securities customers.

Before the decade is out, investors may be connected to the providers of financial services by means of personnel computer linkages.

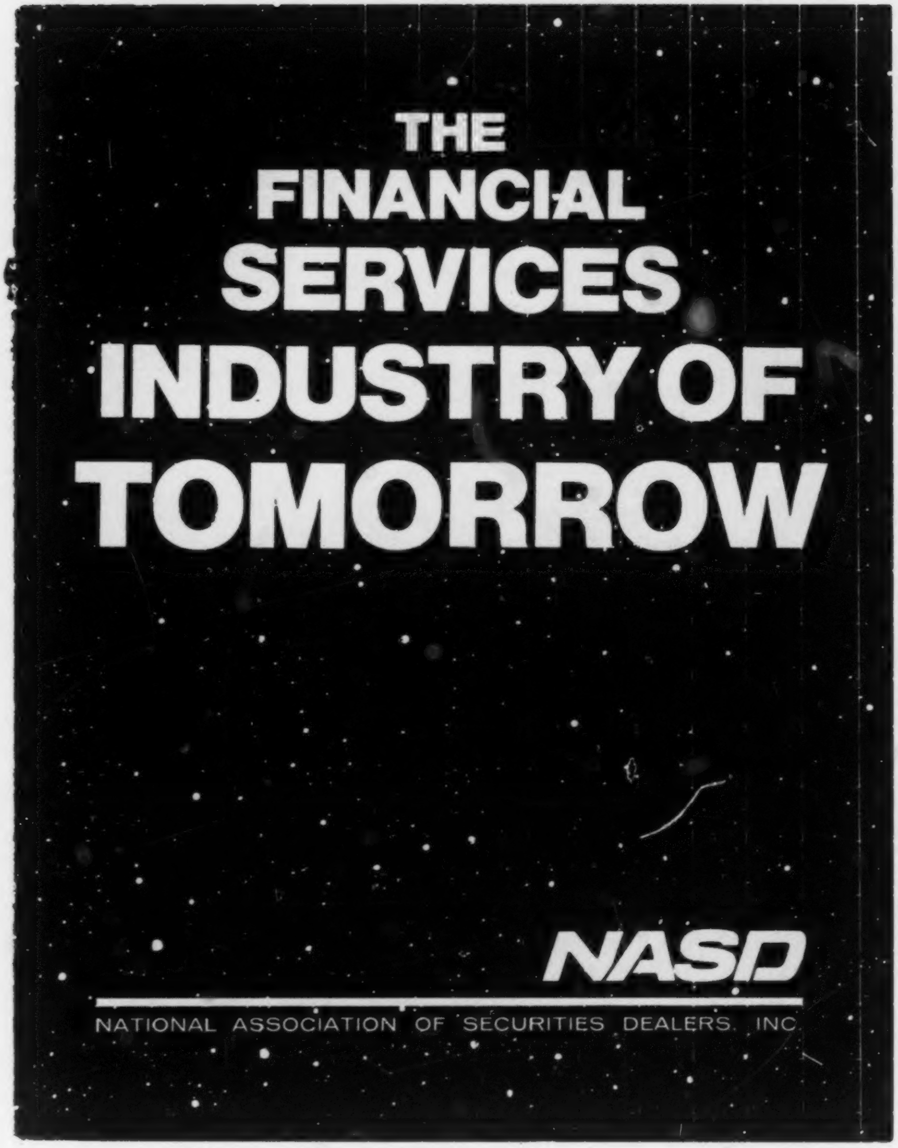
Many new and innovative products and services will be offered in tomorrow's marketplace to fulfill the changing needs of a growing number of investors. The asset management account could be the most important single product innovation of the decade.

Through joint ventures or as a result of the wholesaling of nationally known products by nationally knowns firms, product gaps are likely to be filled for even the smallest of firms.

Greater emphasis will be placed on strategic planning by industry participants as they prepare for the challenges of tomorrow.

The securities salesman of tomorrow will make greater use of technology, sell a vast array of innovative products, become better at giving advice and, as a result, become increasingly more productive. However, due to the impact of multiple client relationships, he will not be as mobile as he is today as customer loyalty begins to shift more in the direction of the firm providing multiple financial services and away from the registered representative selling them.

We would like to reiterate our appreciation for the opportunity to present our comments to you today. We hope our statement will be helpful to you in your endeavors.



THE FINANCIAL SERVICES INDUSTRY OF TOMORROW

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC

THE FINANCIAL SERVICES INDUSTRY OF TOMORROW

A Report Prepared
by the Committee
to Examine
the Future Structure
of the
Securities Industry

November 1982

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET, N.W., WASHINGTON, D.C. 20006

About the NASD

The NASD is the self-regulatory organization of the securities industry responsible for the regulation of the over-the-counter securities market. The NASD was established under the authority granted by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934. As of November 1, 1982, the NASD membership totaled 3,608 broker-dealers, or approximately 90 percent of all broker-dealers in this country doing business with the public. The Association also operates the NASDAQ System through a subsidiary company, NASDAQ, Inc. The NASDAQ System is a computerized communications system which stores up-to-the-second price quotations from a nationwide network of dealers for over 3,700 over-the-counter securities. Through the facilities of NASDAQ, broker-dealers retailing over-the-counter securities to the public as well as professional traders and investors have immediate access to the quotations of all dealers making markets in securities displayed on the NASDAQ System.

The Financial Services Industry of Tomorrow

Table of Contents

Letter of Transmittal
Preface

Chapter I — What Are The Changes Taking Place In The Industry Today? 6

Introduction 6
The Changing Nature of Securities Industry Participants 7
  The New Financial Services Conglomerate 8
  Other Emerging Financial Conglomerates 11
  The Shrinking Network of Regional Firms 11
  The New Specialty Firm 13
  Bank and S&L Entry Into the Securities Business 14
    The S&L Industry 14
    Bank Entry Into the Securities Industry 17
New Products Explosion 18
The Application of Technology In The Industry — Its Growing Uses 21

Chapter II — Why The Change — What Has Happened To The Environment? 24

Changing Government Attitudes and Policies Towards the Financial Services Industry 24
Inflation/Interest Rates 28
The Role of Technology — The Needs That It Fills 29

Chapter III — What Is The Outlook For The Future? 31

Introduction 31
Tomorrow's Consumer of Financial Services 31
The Future Providers of Financial Services 34
  Increased Emphasis on Technology 35
  Industry Composition and Structure 38
Tomorrow's Registered Representative 46

Chapter IV — Summary Of Findings 48

—NASD

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

LETTER OF TRANSMITTAL

November 22, 1982

TO ALL MEMBERS:

In May, 1981, the National Association of Securities Dealers, Inc. (the "NASD"), organized a committee of securities industry representatives to study our rapidly changing industry and the pertinent developments affecting its future structure. The Committee is composed of H. Lawrence Parker (Committee Chairman), Managing Director, Morgan Stanley & Co. Incorporated, New York, New York; William B. Madden, President, Schneider, Bernet & Hickman, Inc., Dallas, Texas; James J. McCormack, Vice President, Metropolitan Life Insurance Co., New York, New York; L. C. Petersen, President, Kirkpatrick, Pettis, Smith, Polian Inc., Omaha, Nebraska; James W. Ratzlaff, Executive Vice President, Capital Research & Management Co., Los Angeles, California; Ernest F. Rice, Jr., Chairman, Executive Committee, Blunt Ellis & Loewi Incorporated, Milwaukee, Wisconsin; and, John A. Wing, President and Chief Executive Officer, The Chicago Corporation, Chicago, Illinois.

The principal responsibilities of this Committee are to assist the NASD's Board of Governors in the formulation of long range policy planning by seeking to interpret current trends and by forecasting their future direction. The Committee is also responsible for furnishing recommendations to the Board with respect to proposals of various kinds which are likely to impact upon the future structure of the securities industry.

In pursuing its assignment, the Committee met with and received a number of excellent presentations from prominent government officials and industry personalities from whom a great deal was learned. The individuals who met with the Committee and thereby provided the Committee with valuable assistance in its fact-finding and data-gathering efforts were Secretary of the Treasury Donald T. Regan; Roger W. Mehle, Assistant Secretary for Domestic Finance, Department of the Treasury; Stephen M. Ege, Elias & Matz (counsel to several savings and loan associations seeking to form a financial services company); Peter A. Cohen, Vice Chairman and Chief Operations Officer, Shearson/American Express; Andrew J. Melton, Jr., Chairman of the Sears Financial Planning Committee and Chairman of the Board of Dean Witter InterCapital Funds, Dean Witter Reynolds Organization, Inc.; James W. Fuller, Senior Vice President, Charles Schwab Corporation; Robert P. Rittereiser, Executive Vice President, Merrill Lynch, Pierce, Fenner & Smith Incorporated; Garnett L. Keith, Executive Vice President, The Prudential Insurance Company of America; Thomas E. Holloran, Chairman of the Board and Chief Executive Officer, Inter-Regional Financial Group, Inc.; and, James L. Bayless, President, Rauscher Pierce Refsnes, Inc. The Committee was also assisted by Douglas F. Parrillo, Vice President, Policy Research of the NASD, who served as the primary draftsman of the report which follows.

Through its deliberations and meetings with its many guests, the Committee perceived a number of emerging consensuses. Chief among these is the fact that our business is rapidly changing and, from all indications, is likely to continue to change at an accelerating rate. Other areas in which consensuses seemed to be forming were that the crumbling of long existing regulatory barriers will result in new sources of marketplace competition as well as many new business opportunities; tomorrow's securities firms will require state of the art technology and telecommunications capabilities in order to compete; new securities products and services will continue to be introduced at record rates as firms seek to fulfill the emerging needs of clients; notwithstanding the adoption of Rule 415, by building on strengths, the prospects for survival of independent regional firms in the financial world of tomorrow are bright; the principal beneficiary of much of the change underway is the consumer of financial services; firms will endeavor to develop multiple relationships with their clients in order to overcome the lack of customer loyalty to any single institution; to minimize the cyclical nature of the securities business, an increasing number of firms will diversify and expand into non-financial activities; and, via an assist from technology, the registered representative of tomorrow will make greater use of electronic equipment, market expanded product lines, become better at rendering advice and, in so doing, become more productive but less mobile. These findings as well as many others are discussed in the Committee's report.

This report does not presume to have all of the answers as to where our industry is going, how it is going to get there, and what needs to be done to assure a firm's future survival. No one possesses the divine powers required to make such forecasts or to provide those kinds of guarantees. What this report does, however, is to combine in a single document the collective thoughts of this NASD Committee, several high-ranking government officials and various industry leaders who unselfishlessly provided the Committee with valuable input with regard to how they see the decade ahead unfolding.

We are hopeful that this report will provide members with a framework from which they may be able to put some thoughts in order in making preparations for the future through the development and/or refinement of effective business strategies. In light of the rapid and profound changes occurring in our industry, we would welcome the views of anyone reading this report.

Ernest F. Rice Jr
Ernest F. Rice, Jr.
Chairman

Gordon S. Macklin
Gordon S. Macklin
President

Preface

This report has been prepared by the Committee to Examine the Future Structure of the Securities Industry, a committee which was formed by the NASD for the purpose of analyzing and interpreting current developments and trends so as to assist the NASD and its membership in its anticipation of and preparation for the future.

As discussed in the report, our industry has entered an era of significant change — change so profound that it will forever alter many, if not all, of our traditional ways of doing business. Each change that takes place seems to trigger still more change with the result being that events of far-reaching importance are occurring at an ever-accelerating rate. Barely a day can go by without reading in the financial press of another new security product or service being developed; another new use of telecommunications or other evolving forms of technology being introduced to accelerate either the flow of financial information to investors or the prompt completion of their transactions; or, another merger, consolidation or combination of securities firms, securities firms and financial intermediaries of various kinds and securities firms and others who normally operate outside of what is generally considered to be the financial services community.

What is happening today in our industry is tantamount to a revolution in the way business has been done and the way investors have been served for many, many years. Even the name of our industry is changing from what many consider an outmoded and obsolete term — the "securities industry" — to one which is thought to be more descriptive of our business — the "financial services industry." In response to a changing environment, the very structure and composition of our industry has begun to change.

As a general proposition, our human nature causes us to fear change mainly because we cannot predict or forecast with perfect accuracy the outcome of change. Because the future is unpredictable, we grow anxious over the prospect of how our businesses and we, in turn, as individuals will be affected by change. Because we have been successful in the past is no assurance that we will be successful in the future. The decision to do business tomorrow the way it is done successfully today may, in a rapidly changing environment, breed failure. Change, however, also works to provide an aura of excitement via a myriad of new opportunities for the highly spirited, entrepreneurial types so plentiful in our business who recognize that survival in the world of tomorrow must not be left to chance. Without question, the ability to compete successfully in the financial services industry of the future will be a function of exactly how well firms plan, how well they prepare, and thereafter, how well they execute their business strategies. Effective planning and preparations are the keys to survival.

As every corporate planner knows, the planning process requires a thorough understanding of the environment in which his firm operates and what is happening or what can be expected to happen to that environment. These assessments are the critical points of departure in the development of business strategies. The purpose of this report, therefore, is to provide members and others who are seeking to understand the changing nature of the financial services environment with information that they may wish to incorporate in their planning efforts. By means of this report, the Association seeks to convey the Committee's findings in terms of what it, as well as other knowledgeable people, see on, as well as over, the horizon for our industry. To do this, the report takes a look at what is going on in our industry today — in terms of the changing nature of securities industry participants, product evolution, and increased reliance on automated systems. It then seeks to explain the reasons for this change with considerable focus given to the crumbling of many of the regulatory barriers to competition, the forces of inflation and interest rates, and the recent advances in technology and telecommunications. The report then considers what the likely impact of all of this will be on the consumer of financial services. The importance of technology and telecommunications, its costs and its uses in the financial services industry of tomorrow are discussed next. Finally, the report offers some possible scenarios on the structure and composition of the financial services industry of tomorrow.

Although this report is intended for all members, it should be of particular interest to those who are in the process of fine-tuning their long-term business strategies. It should also be helpful to those who have not had the opportunity, as has the Committee, to talk with and question knowledgeable industry leaders and high-ranking government officials about their thoughts concerning the financial services industry of tomorrow. The information shared by these very informed people was extremely helpful to the Committee in its data-gathering and fact-finding efforts.

I. What Are The Changes Taking Place In The Industry Today?

Introduction

In response to a rapidly changing environment, the securities industry, long a bastion of tradition and age-old customs and practices, has itself begun to undergo considerable change. It is an industry in transition. Many of the changes now taking place have become evident to even the most casual observer of our business. In many respects, these changes and those which will occur tomorrow are being dictated by changes taking place in our external environment over which we have little, if any, control. They include such things as government policies and attitudes toward the financial services industry, volatile economic conditions — including double-digit inflation and interest rates, and galloping technology and innovation.

This very complex set of inter-related environmental factors has been quick to bring about a substantial amount of change in our industry in a relatively short period of time. The most obvious change is that which involves industry participants. Since 1981, via a swift series of combinations of some very large financial and non-financial organizations, we have witnessed the formation of the so-called "financial services conglomerate" where one-stop shopping for such things as securities, insurance, banking services and many other items is quickly approaching reality. Through a variety of acquisitions by national full-line firms, we have also seen a shrinking network of independent regional firms. We have observed as well that smaller specialty firms, which have carved out special niches for themselves, have entered the marketplace in surprisingly large numbers. We see, too, that aggressive steps are being taken almost daily by banks and savings and loan associations to gain a foothold in the securities business.

In addition to the changing nature of industry participants, several other changes of significance are occurring in the industry at an exceptionally fast pace. The first of these involves the explosion upon the marketplace of a countless array of innovative products and integrated financial services. Asset management accounts and numerous packaged products with an assortment of add-on features have led the way. Another fundamental change taking place in our business involves the growing acceptance of, as well as practical necessity for, sophisticated automated systems not only to process business but also to compete for and retain clients. Many believe that the customer of tomorrow will insist on up-to-the-minute investment data and account information as the price to be paid for handling his account. A growing emphasis on strategic planning as a means of identifying business opportunities wherever they may lie is an equally important but somewhat less obvious change now occurring in our industry.

The origins of the movement towards today's evolving financial services industry go back a number of years. There is a substantial amount of evidence to suggest that the evolution of our industry has been underway for quite some time and that much of it has not happened by accident. One of the first indications of where the industry might be headed is clearly traceable to the 1970 Annual Report of Merrill Lynch. The report contained a number of far-reaching, up-front statements about where Merrill Lynch proposed to be at the end of the decade. In this Annual Report, Merrill Lynch said that "The securities industry of the seventies is going to bear little resemblance to the present one... Tomorrow's customers will want to find all those services [investments, tax guidance, insurance and estate planning] under one roof. Seeing that emerging need, we are determined that we shall be there to fill it. Our concept for the Merrill Lynch of the future is that it should provide complete financial service." Similar forecasts and projections began appearing shortly thereafter in the annual reports of other prominent securities firms.

In addition to the aforementioned external environmental forces, there have been a number of environmental factors of an internal nature at work within the industry itself that did much to recast the underpinnings of our business and, even now, continue to influence a fair amount of today's events. Perhaps, the most important internal change to have taken place in our industry in the last two decades involved the geometric increase in the amount of attention, time and money spent on management. As recently as the 1960s, much of the securities business was essentially run by a cottage industry-type management. That indeed has changed. Today's industry leaders have developed a heightened interest in planning and management, particularly, as mentioned, strategic planning.

The second major change which has had a continuing impact on our industry was the unfixing of commission rates. Ten years ago, the percent of total industry revenues derived from agency commissions was roughly 66⅔%. Today it is less than 30%. History has shown that firms are quick to abandon, or at least de-emphasize, business lines that are not as profitable as before by reallocating their resources to more productive pursuits. The management and planning process has pointed out to securities firms that there are other ways to make a living besides executing agency transactions.

The Changing Nature Of Securities Industry Participants

Businesses are not unlike individuals in that each responds to change differently because it perceives the factors influencing change differently. In that connection, many participants both within and outside of our business have developed different business strategies and taken an assortment of actions to position themselves for the future as they envision it. These actions are in response to their assessments of the current environment and their perceptions as to how it is likely to change.

The New Financial Services Conglomerate

The single most important event of recent vintage which turned the evolutionary change going on in our business to what seemingly amounts to a revolution occurred in March, 1981, when Prudential Insurance acquired Bache Halsey Stuart Shields. In many respects, the shock waves sent throughout the street by this development have not yet fully subsided. The decision to buy Bache was an outgrowth of Prudential's long-range planning efforts and its assessment of the environment which lies ahead. As the Committee learned from Garnett L. Keith, the following environmental factors were identified by Prudential as collectively contributing to the change our industry is experiencing and, in large measure, greatly influenced its decision to buy Bache:

- *the growth of special interest groups and their impact on government's ability to control its fiscal bounds and, hence, inflation;*
- *the effect of inflation on real income and savings of the middle class, thus making the middle class investor increasingly more financially sophisticated;*
- *the rising level of education creating a population more inclined to think for itself;*
- *demographic data that looks very different from 20 years ago including, among others, that:*
  - *the children of the post-War baby boom are now entering the 35 to 44 age group;*
  - *two-income families are now in the majority; and,*
  - *declining mortality is creating a substantial increase in the elderly population;*
- *a continuation of the move off the farm and out of the small towns to become employees of large corporations in the cities. This long-term trend has changed an individual's economic support system from one of self and family to one of reliance on employer and government support systems;*
- *the advent of the computer, video and other technological developments and their use in reducing the cost of information management;*
- *the integration of the world financial community and the collateral demise of traditional barriers between competitors; and,*
- *the rapid escalation of interest rates with one result being that new entrants into the savings competition have a significant advantage over existing entities holding low yielding loan portfolios.*

Prudential's assessment of the environment caused it to conclude that the nation is not likely to need the 25,000 to 35,000 banks, thrifts, insurance companies, larger securities firms and investment counselors of today competing in tomorrow's world for the same customers. In Prudential's view, the consumer of financial services will seek a simplification in the growing number and complexity of his financial relationships. This, Prudential determined, would result in a growing number of consolidations and a blurring of functional distinctions among financial institutions.

In looking at the competitive environment and the dimensions of competition, Prudential also saw the upscale market as being not only attractive in size, growth and profit potential, but also one in which it was not as strongly represented as it wanted to be. Thus, upon receiving a call from Bache's investment banker in the first quarter of 1981 asking whether it would be interested in acquiring the Bache Group, Prudential thought the question through very quickly and presented its final offer within two weeks of the initial inquiry. Its ability to move quickly was due to its understanding of Bache and its determination that Bache was an attractive investment with excellent growth potential; that Bache offered Prudential an ideal vehicle by which to gain a presence in the upscale insurance market; and, that Prudential had the resources to create products which could be successfully marketed through cross-selling efforts of both Prudential and Bache.

According to Peter Cohen of Shearson/American Express, the Bache/Prudential merger was the prime catalyst which caused Shearson Loeb Rhoades to rethink its planning for the future. It was also the event which caused the firm to give serious thought to the concept of a financial "supermarket," i.e., a one-stop financial shopping center. On the basis of research done for it by the Harvard Business School, Shearson determined that tomorrow's supplier of financial services will be required to satisfy a broad range of a person's financial needs through not only a nationwide delivery system but also through personalized customer service. The Shearson people are convinced that consumers of financial services are looking for one place to shop in this ever-growing complex world of investment.

The Bache/Prudential acquisition also paved the way for American Express to do some thinking about where it was going and how it was going to get there. In addition to Shearson's capital base and favorable earnings picture, American Express found the firm's nationwide operations in mainly non-competing areas particularly appealing. Shearson, on the other hand, was intrigued with the idea of being linked to an organization with a strong and positive image with consumers, no competing sales force, and a substantial number of cardholders — all of whom are potential buyers of financial services.

Sears, Roebuck and Co., another relatively new entrant in this business, had for some time been making plans to move beyond its traditional business of merchandising into the burgeoning world of financial services. Sears' reasons for doing this were many. They included the need to offset a maturing retail operation, a familiarity with certain aspects of the financial services world via Allstate Insurance as well as other financial activities related to its enormous merchandising operations, substantial financial resources, and a mammoth customer base, among others.

According to published reports, Sears, Roebuck and Co.'s plans for the future are built upon three critical assessments of the changing competitive environment:

- *that there is a greatly enhanced environment for savings via tax incentives for IRA and Keogh accounts, tax cuts to create new disposable income, and new investment incentives, among other things;*

- *that a revolutionary restructuring of financial institutions is underway; and,*

- *that there is a growing understanding that our economy is indelibly part of the world economy.*

On the basis of its assessment of the environment, Sears determined that the time was at hand for it to take aggressive steps to become a primary provider of financial services. The resources which have been amassed by Sears to fulfill this role include:

- *Allstate Insurance Company — one of the nation's largest insurance companies;*
- *Coldwell Banker — the largest independent real estate broker in the country;*
- *Sears, Roebuck and Co. credit card system with over 25 million regular users;*
- *Allstate Savings and Loan — a large California-based thrift institution; and,*
- *Dean Witter Reynolds Inc. — one of the country's largest securities firms.*

In addition to the more than two times book price paid for Dean Witter stock, Dean Witter's Board and its shareholders found the prospect of being aligned with a massively capitalized firm extremely attractive. Particularly appealing too was having access to Sears' customer base — over 25 million active customers have a Sears credit card. Dean Witter officials point to the fact that three-fourths of all brokerage firm customers with household incomes above $36,000 per year hold the Sears credit card. They believe too that Sears has twice the penetration of American Express among affluent brokerage customers.

For Sears, the acquisition of Dean Witter was simply another step, albeit a major step, in the quest of its management to make Sears the nation's largest "financial service entity." With a number of financial service companies already in place (Allstate Insurance was created in 1931), the acquisition of Dean Witter, the fifth largest securities firm in the nation, has served to put the resources in place for Sears to pursue its goal. Among other things, Sears is already offering its customers money market accounts and IRA account programs and it recently launched a pilot program in which "financial service centers" were opened in eight Sears outlets. A number of other novel plans are currently under consideration by the Dean Witter/Sears management.

Other Emerging Financial Conglomerates

In addition to Prudential, several other large insurance companies, including Kemper, John Hancock, Penn Mutual and Travelers, have broadened their financial services capability through acquisitions of securities firms. The regional firms of Blunt Ellis Loewi Incorporated, Bateman Eichler, Hill Richards, Incorporated, and most recently, Prescott, Ball & Turben, have been acquired by Kemper, while Tucker Anthony, the Boston based parent of Tucker, Anthony, & R. L. Day, Inc., was recently purchased by John Hancock, the nation's sixth largest life insurer. In July, Penn Mutual acquired Janney Montgomery Scott Inc., while Travelers acquired Securities Settlement Corporation. In the past few weeks, it was also announced that Northwestern Mutual agreed to purchase approximately 75% of the common stock of Regis Holdings, the parent company of Robert W. Baird & Co. Incorporated while Phoenix Mutual purchased a 51% interest in Burgess & Leith, Incorporated. Also, The Hartford Insurance Group recently announced the purchase of a 25% minority interest in Wheat, First Securities, Inc. Although these mergers are unlikely to produce giants of the magnitude of Bache/Prudential, Shearson/American Express or Dean Witter/Sears, they represent another step in the general direction of diversification and one-stop shopping for financial services.

The Shrinking Network Of Regional Firms

Although Blunt Ellis Loewi, Bateman Eichler, Prescott, Ball & Turben, Janney Montgomery Scott, Robert Baird & Co., and Tucker Anthony are now owned by insurance companies, it is anticipated that they will retain their regional character. It is expected that their insurance company owners will retain the concept of separate management structures for these regional firms and, for the most part, will permit them to operate autonomously. The same course of action will not be followed for many of the regional firms recently acquired by national full-line firms. With Shearson's recent acquisitions of The Robinson Humphrey Company and Foster & Marshall Inc., as well as Bache's takeover of Elkins & Co., these formerly independent regional firms are, for all intents and purposes, functioning as branch offices of super large organizations headquartered in New York where the majority of management and business decisions affecting these "branch" operations are now made.

The factors most frequently cited for the decline in the number of independent regional firms include the price offered, the escalating costs of technology and telecommunications systems, the need to access a wide variety of products that only a large national firm with abundant resources can produce, age and liquidity problems of senior management and, changes in distribution methods brought about in large part by the SEC's adoption of Rule 415.

Other regional firms have followed somewhat different paths in seeking to solve many of these same problems. The merger of Rauscher Pierce Refsnes with Inter-Regional Financial Group (IFG), a diversified financial services company with subsidiaries engaged in real estate services, equipment leasing, asset management and insurance (as well as announced plans to establish a savings and loan association), was an alternate route taken by the Rauscher organization to deal with the problems noted and, at the same time, to gain stature and added resources without losing its regional character. According to the parent organization's Chairman, Thomas E. Holloran, this approach falls somewhere between "going it alone" and affiliating with the new family of "mega" firms.

According to Mr. Holloran, IFG's decision to diversify into a number of inter-related businesses was prompted by a number of factors:

- *the need to minimize the cyclical nature of securities market activities;*

- *the desire to take advantage of opportunities whenever and wherever they may be; and,*

- *the desire to take advantage of the synergism that exists in having independent units work in cooperative fashion.*

The acquisition of Rauscher Pierce was pursued by IFG so as to strengthen its securities operations and to continue its penetration of markets west of the Mississippi. Also, since Rauscher Pierce and Dain Bosworth, another IFG subsidiary, were at the so-called "cutting edge" of the critical mass needed to support their expanding computer and communications requirements, the ability to now share data processing facilities of both firms is expected to improve operating efficiencies greatly.

While a number of independent regional firms have been acquired and others are in fact looking to be acquired, there is some evidence to suggest too that there are still a number of regional firms which have and will continue to jealously guard their independence and will resist merger advances.

The New Specialty Firm

This period of change which we are in has also given birth to the so-called "specialty" firm — a firm which carves out a special market niche for itself. One of the most successful of these is the discount firm which was born in 1975 with the unfixing of commission rates. This particular type of firm functions purely as agent. Since it never takes a position, it never acts as dealer. The firm does not employ salesmen, thus it renders no investment advice. Also, to facilitate speed and quality of service, it is highly reliant on automated systems to both execute and process orders. By virtue of its method of operation, the discount firm can offer commission rates one-half to three-quarters below conventional rates charged by full-line commission houses. In the competition for investors' funds, some discounters now provide the equivalent of money market accounts complete with debit cards and checkwriting privileges.

Discount firms claim that the majority of their clients are motivated to do business with this type of firm for two main reasons — price and the fact that no sales assistance is necessary. Many discount firm customers do, however, maintain accounts with other firms to fulfill other financial needs.

Because of the nature of its business activities, the discount firm has become extremely attractive to many of the nation's larger banks seeking to establish a beachhead in the securities industry. Under the Banking Act of 1933 (commonly referred to as the "Glass-Steagall Act"), the securities activities of banks are limited to transactions in governments, the underwriting of municipal general obligation bonds and effecting securities transactions in corporate debt and equities on an accommodation basis for existing clients. With possibly few exceptions, banks have not effected transactions on behalf of customers outside of the normal trust account relationship nor have they effected transactions on margin.

The more significant bank in-roads to date via discount operations include BankAmerica's proposed acquisition of Charles Schwab; California based Security Pacific's establishment of a relationship with Fidelity Brokerage followed by recently announced plans to launch its own nationwide discount broker subsidiary; and, the Union Planters National Bank's move to acquire Brenner Steed & Associates, Inc., a local Memphis discount broker. Other large banks are also stepping up plans to form, acquire or make arrangements with discount brokers to provide transaction execution/financing services. Among others, these banks include Citicorp, Chemical Bank, Wells Fargo and Midlantic National Bank. Collectively, these actions represent profound potential for change in our business. According to many, these acquisitions of and arrangements with discount brokers represent a major move by banks into the upscale client market.

The fragmented scheme of regulation to which banks are subject (different banks are regulated by different bank regulatory agencies) has resulted in the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Comptroller of the Currency all separately reviewing petitions from banks seeking approval to commence discount broker operations. The Securities Industry Association, however, has stepped forward and aggressively challenged certain of these actions in court, thereby delaying, at least for the moment, the securities expansion plans of certain of these banks.

In recent months, a number of discount brokers have expanded their operations to the point that they are now providing quotes and accepting orders on a 24-hour-a-day basis. According to James W. Fuller of the Charles Schwab Corporation, this type of business entity, structured as it is, could easily be used to market a wide variety of financial as well as non-financial products, provided the products are easily understood by consumers and, as such, not in need of the types of explanations normally provided by salesmen.

Other types of specialty firms are also emerging. These include the tax shelter or "direct participation" firms, as they have become known (and which have entered the marketplace in surprisingly large numbers) and the so-called boutiques which have sought out other specialties and market niches. By concentrating their energies in limited fields of expertise, they are able to compete on the basis of quality of service. Although the upscale customer is the normal target of the boutique firm, it will also provide its specialized services to a particular market segment, a specific product or a geographical area. The boutique of growing importance today is the investment management firm. Although there are other types and forms of boutiques, they all have several characteristics in common. That is, they conduct a business that is limited in scope, provides personalized service, is staffed by experts and, because of its size, is more manageable than its full service competition.

Bank And S&L Entry Into The Securities Business

The S&L Industry

From all indications, the $900+ billion thrift industry is experiencing very difficult times. It seems that just about every day we hear another newscast or read another news report about the merger of still another ailing thrift. The "5% passbook" savings account has quickly become extinct and is no longer the traditional source of funds for the S&L industry as savers seek money market rates and other investment alternatives. As a result, savings deposit costs and sagging earnings on large holdings of old, low-yield mortgages have caused massive operating losses and rapidly deteriorating net worth positions for many of these institutions. Many feel that if the situation is not soon reversed, the very viability of the thrift industry is threatened.

In response to this problem, a number of actions have, in fact, been taken. Legislation to strengthen the financial stability of home mortgage lending institutions was recently passed by the Congress; the Federal Home Loan Bank Board, the regulator of the industry, has authored a number of creative proposals to expand the powers of S&Ls; and, on their own, several S&Ls have developed plans to establish a financial services company. The latter two items are particularly germane to this study of the evolving structure of the securities business.

The FHLBB's proposal, currently awaiting action by the Board, would permit S&Ls to engage in the following new business activities without prior approval by the FHLBB:

- *real estate brokerage;*
- *the manufacture of mobile homes;*
- *commercial lending without restrictions;*
- *leasing of consumer and business goods;*
- *insurance underwriting;*
- *debt collection services;*
- *expanded loan servicing;*
- *coin and currency services;*
- *preparation of tax returns for businesses;*
- *investment in certified development companies;*
- *issuance of letters of credit;*
- *acting as a futures commission merchant; and,*
- *engaging in various securities activities such as acting as broker and organizing and selling shares in mutual/money market funds.*

The FHLBB's purpose in proposing these added powers for S&Ls was, according to Board Chairman Richard Pratt, to bolster an S&L's ability to make fixed rate mortgages by giving them additional ways to make money to fund those loans. Some on the Hill have taken exception to the administrative approach of the FHLBB in moving to restructure the thrift industry believing that it is the responsibility of Congress to respond to the problem through legislative change. Others, namely the U.S. League of Savings and the National Savings and Loan League, have endorsed the proposal while, from a securities industry perspective, the SIA has taken exception to the proposed securities powers for S&Ls.

As to the second item, three S&Ls joined forces last year to form a financial services company (the Savings Association Investment Securities — "SAIS") both to act as brokers and to organize, sponsor, operate, control, and render investment advice to an investment company. According to Stephen M. Ege, counsel to SAIS, the S&L industry is searching for additional ways to generate added income to offset cyclical fluctuations in the cost and availability of money. What the industry needs, he advised, are products to sell with less risk, products not tied to interest rates and/or products, though interest rate-related, that belong to someone else. The fact that S&Ls currently do business from over 20,000 nationwide locations coupled with a stated desire to market securities products of others through what amounts to a nationwide distribution network raises the spectre of profound change for the emerging financial services industry. In early May of this year, the FHLBB approved the application of the petitioning S&Ls. On July 7th, the SEC decided not to block the application by authorizing the staff to issue a no-action letter stating that SAIS could do business from the premises of participating S&Ls without requiring the individual S&Ls to register as broker-dealers under Section 15 of the Securities Exchange Act of 1934. The S&Ls sought this action since the large majority of them would be unable to meet the liquidity requirements under the SEC's net capital rule — a rule to which they would have been subject had they been required to register as broker-dealers.

Disappointed with the SEC's action, the SIA has filed suit against the FHLBB claiming that the agency violated Glass-Steagall and the Home Owners Act of 1933 by approving the application of the three S&Ls to form SAIS. Thus, for the time being, it is unclear as to where these developments will lead. Other developments, jointly affecting S&Ls and securities firms, which seem to be on faster tracks, include previously mentioned Inter-Regional Financial Group's plans to form an S&L, Dain Savings Association; and, Fidelity Brokerage Services' recent agreement to provide discount brokerage services to Home Federal Savings & Loan of San Diego in addition to a growing number of banking institutions.

Bank Entry Into The Securities Industry

The banking industry, like the securities industry, has perceived a changing environment and many are aggressively responding to it. More sophisticated customers with changing needs, advances in technology, relatively high interest rates, the emergence of money market funds and the so-called asset management account and deregulation are but a few of the forces at work in reshaping the banking industry's environment. These are many of the same environmental factors at work in reshaping the securities industry. As common interests and pursuits emerge, areas of inter-industry cooperative action appear. At this early hour, there are countless instances of business relationships between banks and securities firms that as recently as five years ago most would have thought to be sheer fantasy, e.g., the interaction of banks and broker-dealers in providing the public with asset management accounts and various kinds of sweep arrangements.

The bankers argue that their ability to respond to their rapidly changing environment, unlike their securities industry counterparts, has been curtailed and hindered by restrictions on interstate banking, the Bank Holding Company Act of 1960 which limits bank activities to those closely related to "commercial" banking, and the Glass-Steagall Act which separates "commercial" from "investment" banking. (As noted, however, Glass-Steagall does permit banks to effect securities transactions on behalf of existing customers on an "accommodation" basis.) Bankers, like securities firms and others in the financial services field, feel threatened by the changing environment. Their measured response has been to call for a "level playing field" upon which institutions, which are becoming more and more alike in terms of products offered and needs satisfied, may have an equal ability to compete. Bankers claim that many securities firms are drawing off their customers by offering products and services long associated with depository institutions and thus are enjoying a competitive advantage over banks which have more in the way of hurdles to overcome in seeking to sell securities.

To some extent, many in government seem to share these views. Some months ago, Secretary Regan advanced a Treasury Department proposal which would have permitted banks to engage in a full array of securities activities as well as other financial services including leasing, real estate and insurance. The proposal would have required that all securities activities be conducted by a separate bank subsidiary which would have been required to register with the SEC as a broker-dealer. Thus, from the perspective of equal regulation, all securities activities, whether performed by banks or broker-dealers, would have been regulated by the same entity. With some modification, the concept of a separate securities affiliate was endorsed by the SIA which commented that "... the securities industry was gratified that the Administration acknowledged that banks do have significant unfair competitive advantages by reason of their status as banks when they compete with securities firms." Among the advantages referenced by the SIA in this context are a lower cost of capital, more favorable tax treatment and captive markets.

As of today, the Treasury Department proposal has not been introduced in Congress. However, in October 1981, S.1720, a composite deregulation bill, was introduced by Senate Banking Committee Chairman Jake Garn (R-Utah). Senator Garn's bill was designed to not only give more powers to thrifts but, among other things, would have also given commercial banks authority to underwrite municipal revenue bonds and to sell money market funds. Unlike the Treasury proposal, there would have been no requirement that these activities be carried out by a separate bank subsidiary. The bill, since enacted into law and designated the Depository Institutions Act of 1982, was stripped of several of its more controversial provisions, including Title V relating to money market funds and municipal revenue bonds. This was done in order to get expedited action on the more critical aspects of the thrift industry assistance legislation. Senator Garn and members of his Committee did, however, pledge consideration of the securities issues as a first priority next year.

Despite the current flurry of activity on the Hill to commence work on developing a legislative framework to accommodate increased participation by banks in the securities side of the financial services industry, many would argue that such participation has already occurred on a de facto basis via the recent actions by banks to acquire, affiliate with and establish discount brokerage firms.

New Products Explosion

As a complement to the diversification process now going on in our business, particularly among larger firms, another form of diversification is occurring. It involves the creation of a whole new assortment of products both to supplement existing product lines and to satisfy changing investor needs. Part of this, of course, is due to the fact that securities firms operate in a highly competitive environment with the prospect of some very tough competition around the corner. Perhaps more importantly is the fact that these are times in which today's investor has rapidly matured. As William Schreyer, President of Merrill Lynch & Co., recently said, "... consumers of today are more educated, knowledgeable and mobile. Their resources, even their very lives, are more and more affected by inflation." These and other factors, he said, "... [have] resulted in making people, especially the more affluent, more interested in integrated planning and management of their financial affairs and receptive to new services and packages of financial instruments that help meet their needs."

Today, there are an almost unlimited number of products from which the investor can choose. The proliferation of new products besieging the marketplace has been nothing short of astounding. These newly introduced products include asset management accounts, money market funds, various kinds of financial instruments as well as options and futures on those instruments, direct participation programs, standardized equity options, floating rate notes, zero coupon bonds, universal life insurance, an expanded assortment of variable contracts, all-savers certificates, real estate securities and precious metals, to name but a few. Other long-existing products, such as municipal securities, limited partnership interests and certificates of deposit, due to an interaction with the tax system and/or attractive rates of return, have generated substantial investor interest and are currently being actively marketed throughout the industry. Not to be overlooked too is the fact that daily market data attest to a renewed interest in equities and corporate and municipal bonds as attractive investment staples.

Perhaps the product which has generated the most discussion and controversy in recent years is the asset management account. Originally introduced by Merrill Lynch in 1977, this unique product combines the features of a brokerage margin account, a line of credit, a money market fund, and the ability to access both assets and borrowing power through a check or a credit card. In its 1981 Annual Report, Merrill Lynch states that after less than five years, the firm now serves well over half a million CMA clients. (The Cash Management Account, or CMA, is Merrill Lynch's trade name for an asset management account.) A number of the larger firms have recently introduced similar types of accounts with a host of varying features. In this second generation of asset management accounts, not only do minimums vary from one sponsor to another, but some have also added such sweeteners as travelers checks, credit cards and/or check cashing privileges. One even offers insurance protection on balances above and beyond that provided by SIPC while another provides a 1% rebate on card transactions. As this type of account continues to proliferate, other variations are bound to appear.

In an effort to retain depositors, the banking industry has launched a counteroffensive by introducing products which are closely related look-a-likes to the asset management accounts found in the securities industry. To do this, a number of banks have moved to establish arrangements with mutual fund sponsors to offer what are commonly referred to as "sweep" accounts whereby balances are switched out of savings accounts into the higher yielding money market funds. Others are coupling "sweep" accounts with collateral arrangements with broker-dealers to provide securities execution services on a discount basis. Other banks, which have gone the route of creating their own mutual funds, and VISA, which has also proposed a fund (which would reinvest fund proceeds in CDs of participating banks through a form of reciprocal arrangement), have run into some difficulties in getting their funds approved by the SEC.

The fact of the matter, however, is that the asset management account, which links securities, banking and trust services under one roof, is a very innovative and appealing product and one which, in the opinion of many, may very well be the single most important product of the coming decade.

The money market fund, an integral part of the asset management account, has on its own been a major new product development. The impact of this product on the market is amply demonstrated by the fact that since 1974, when there were but 15 funds having $1.7 billion in assets, there are now more than 180 funds with total assets in excess of $200 billion. The popularity of this product is traceable to the fact that it is a relatively safe, highly liquid and professionally managed investment which pays market rates and which comes with other features such as checkwriting privileges. It is not only popular with investors but also with securities firms since by putting an investor's assets under its control, it generates significant management fees and provides a future source of investable funds.

The tax shelter or direct participation program field has also gained in popularity as our per capita income has risen and we look for legitimate ways to defer and/or minimize current tax obligations. In 1974, a total of $1 billion of these products were publicly offered through NASD members. For the year 1981, the dollar volume of these programs so offered passed the $12 billion mark. In addition, although data is not available, private placements of direct participation programs are estimated to equal the dollar amount of those offered publicly.

The success of equity options programs during the 1970s is well known. Financial futures, somewhat slow leaving the gate, have picked up some momentum and have gained in popularity with institutional investors as our economy remains volatile. Sales of insurance-related products too have picked up steam and are likely to accelerate as a result of the synergism produced by several of the recent mergers of broker-dealers with insurance companies.

Stock index futures, perhaps the newest product on the scene, have already been branded a success by many. These products enable investors to hedge or trade against overall market movements. Index futures can now be purchased on the NYSE Index, Standard & Poor's 500 Index and the Value Line Index. A sister product to the index future, the stock option index, is about to be launched following SEC approval. Awaiting approval too are options on exempted debt securities. The new products list goes on and on.

In summary, it suffices to say that many new and sophisticated products have come to market to fill investor needs and to provide participants with a competitive edge in the quest for investor funds. With ingenuity so pervasive a force in this industry and with technology continuing to evolve, more innovative and creative products are inevitable.

The Application Of Technology In The Industry — Its Growing Uses

In our business, we find many new and unique applications of technology rapidly changing our traditional ways of doing things. We are conditioned to adapt to change so quickly today that we oftentimes get trapped into thinking that these new uses of technology have been around much longer than they actually have. Technology becomes so much a part of our daily routine that we not only take it for granted, but we also become almost totally dependent on it. The growth of our business in terms of both share volume and new products is such that it is inconceivable that we could do business today the way it was done a mere fifteen years ago. Reflecting back, we will recall that it was not too many years ago when:

- *there were only a handful of firms with automated recordkeeping systems;*
- *there was no NASDAQ System to facilitate trading in over 3,700 over-the-counter issues;*
- *there was no National Securities Clearing Corporation to provide a nationwide continuous net settlement system or a network of depositories to facilitate the completion of transactions between professionals;*
- *there was little, if any, capability for a registered representative to call up customer account information on an on-line basis;*
- *there was no composite quotation system or intermarket linkages;*
- *there were few, if any, internal order routing systems or automated execution systems in place such as CAES, SCOREX, PACE, DOT and others;*
- *there were no sophisticated automated trading strategies in place to guide buy and sell decisions in the not-yet-developed standardized options programs of the exchanges;*
- *there were very few desk top terminals linking salesmen with price information to communicate to their clients;*
- *there were no highly sophisticated, technology supported products on the market such as the asset management accounts; and,*
- *the many, many more uses to which technology has since been put had not as yet unfolded.*

Today's securities firm, via technological innovation, has instantaneous access to information worldwide. It also has the ability to effect transactions on an international basis as easily as if it were doing business down the street. For the providers of financial services, technology has bridged the gap of time and space by means of remarkable delivery systems.

The securities industry is not the only industry awash in technology. The banking industry, too, is changing dramatically because of technological advances. Electronic banking via the automated teller machine and its use in network arrangements is revolutionizing the banking industry. As Citicorp said in its 1981 Annual Report:

> *Technology has changed forever the way people communicate, the way they live and transact business, even the way they relate to money. Banking as we used to know it is being replaced by a new form of financial intermediation. Some prefer to call it electronic banking or electronic funds transfer -- a futuristic idea only a few years ago. By whatever name, the phenomenon revolutionizing our industry — and the world as well — is the instantaneous exchange of funds and information by electronic means.*

Clearly, transaction processing and dissemination of information in the financial services industry have experienced earthshaking changes. Technological change in and of itself has stimulated many in the financial services industry to reshape and redirect their businesses. Technological advances have also facilitated the creation of many new products and services that have been introduced in the marketplace to fill the changing needs of consumers. Among other things, technology has also raised the price tag for being a competitor in tomorrow's marketplace, especially for those who wish to become full range competitors. Sophisticated data processing and information systems have never been inexpensive. Technology has also begun to tear down the traditional concepts of doing business from fixed locations and the need to have physical proximity to a customer. Brick and mortar structures are becoming less and less important in the scheme of delivery systems for financial services, particularly those which are deposit related. Walter B. Wriston, Chairman and Chief Executive Officer of Citicorp, and John Fisher, Senior Vice President of Bank One Corp., among others, see the home computer with video links as one of the most important technological developments for the financial services industry in the next decade.

Technology has also been used to facilitate mass marketing operations, such as those involving money market funds and discount broker operations, and it is certain to spur still others.

Technology, particularly the development of the so-called microprocessor, has given birth to the microcomputer, a major innovation now priced well within the reach of even the smallest of firms. Although these small computers are a far cry from what either minicomputers or large main frame computers are capable of doing, they do provide the smaller firm with a resource to fulfill limited client needs at reasonable prices.

As George Kaufman, Professor of Economics and Finance at Loyola University of Chicago, points out, the advent of the "800" telephone number was a simple but nonetheless major technological breakthrough. By bridging geographical constraints, he points out, the 800 number allows single office firms and money market funds with little more than one office and frequently no more than a dozen employees who man the 800 number to compete with the giants. Many of us use the 800 number every day without giving much thought to its far-reaching implications.

The growing use of technology in our business is pervasive. There is little that we do either in our own firms or in interacting with others that was not made possible by technology. In his book *Future Shock,* Alvin Toffler points out that technology feeds on itself. Technology makes more technology possible and it can be demonstrated, he says, that the tie between each of the steps in the cycle continues to be shortened. If he is right, as events in our own business would suggest he is, more sweeping change at an accelerating rate lies ahead.

In the last chapter, we took a long look at what is going on today in our industry. This chapter explores in some depth the reasons for this change. The principal areas of focus are changing government attitudes and policies toward the financial services industry, volatile economic conditions coupled with double-digit inflation and interest rates, and galloping technology and innovation. The following discussion is not intended to be all inclusive but rather, is designed to identify some of the more significant reasons "why" our industry has changed.

Changing Government Attitudes And Policies Towards The Financial Services Industry

The Reagan Administration has frequently expressed its concern over the health and well-being of the business community and in that connection, it has taken a number of actions. In addition to the tax-cut program and efforts to reduce government spending, regulatory relief is one of the principal cornerstones of the Administration's economic, or as it is inclined to say, its "pro-market" program. In that regard, Vice President George Bush has been appointed Chairman of the President's Task Force on Regulatory Relief which has the assignment of identifying regulatory programs of the federal government which are unnecessary and those which are unduly burdensome and not cost effective. As evidenced by the creation of this Commission and the numerous actions taken by many of the departments and agencies of the federal government, deregulation of American business has been elevated to a high priority.

The Administration's deregulation philosophy is exemplified best in a recent statement by Roger W. Mehle, the Treasury Department's Assistant Secretary for Domestic Finance, who said that "[W]e start with the perspective that the market has already changed, and that the regulators, and the rest of the government, including us [the Treasury Department] are 10 years behind. We are simultaneously trying to catch up and get out of the way; indeed you might say that we are trying to catch up by getting out of the way."

As Secretary of the Treasury Regan said, "Regulation should secure the public interest, not protect the special interest. As the public interest changes, so too should the regulations intended to guard it. No regulation should — nor will — be eliminated simply because it restrains. But no regulation should — or will — be preserved simply because it is popular with a vocal constituency."

It is probably quite true that the marketplace is outpacing its regulatory framework. Many have observed that when the regulatory structure for the financial services industry finally begins to take shape, it will simply confirm that which already exists.

In many respects, much of the jockeying for position now occurring among those seeking to be the future providers of financial services is taking place not so much because specific regulatory barriers artificially restricting the industry's participants have been removed, but rather because there is great anticipation that such will happen. Indeed, there are many indications that these changes are around the corner. As noted in the last chapter, banks are buying broker-dealers and broker-dealers are buying trust companies, forming savings and loan associations and are being acquired by both large financial and non-financial corporations. This list of changes could go on. Very little of this has happened because legislation has been enacted or because regulations have been adopted to permit it. Rather, it is based on the emerging view that, given the element of time, the regulatory apparatus to govern all of this will, as Mr. Mehle points out, ultimately catch up. Certainly times have changed in terms of players participating in the marketplace, the products that they sell, the availability, quality and timeliness of market information being provided, and the nature of delivery systems used to transmit information and effect transactions. Notwithstanding these profound changes, with relatively few exceptions, the regulatory framework governing all of this is much the same as it was when it was created in the 1930s. As Treasury Secretary Regan said, the legislation governing this emerging industry is out of date and "... designed for a world that no longer exists."

Although there are relatively few concrete examples to point to as evidence of a changing regulatory environment for the financial services industry, there is much to suggest rapidly changing attitudes in Congress and elsewhere among the numerous financial services regulatory agencies. Numerous clues also abound as to what lies over the horizon.

One of the more significant legislative steps toward deregulation of the financial services industry occurred with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. This bill was enacted to allow thrifts to become more competitive by phasing out the ceilings on interest rates that they may pay depositors. Broader emergency legislation in the form of the recently passed Depository Institutions Act of 1982 has now expanded the range of services thrift institutions may provide and, among other things, phases out by June 1, 1984, all interest ceilings on deposit accounts. In due course, this legislation may well be the forerunner of more extensive change in terms of removal of other barriers to competition among tomorrow's providers of financial services.

Other indications of changing government attitudes can be found in the pronouncement of many leading legislators who are becoming more and more vocal in their insistence on a thorough re-examination of Glass-Steagall. Senator Garn, as noted earlier, in his capacity as Chairman of the Senate Banking Committee, has stated that his Committee will take up Glass-Steagall and related matters next year.

Previously Garn introduced legislation, now tabled, which would have allowed banks and other financial institutions to operate money market funds and which would have allowed banks to underwrite municipal revenue bonds.

On the House side, several members of the Banking Committee have expressed concern over the prohibitions relating to bank underwriting and commingled agency accounts and have called for a comprehensive review of Glass-Steagall and other bank issues. As recently as August, Timothy E. Wirth (D-Colo.), Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance, introduced legislation in the House calling for the creation of a Commission on Capital Markets to work closely with the Congress in examining such questions as the adequacy of capital formation in this country and the continuing viability of laws regulating the financial intermediaries that raise and allocate capital. He said that "... the proliferation of new financial instruments in the market, mergers among financial and non-financial institutions, and the general homogenization of institutions offering financial services, reflect dramatic changes in those roles. Distinctions between classes of institutions that were previously maintained by statutory boundaries are disappearing in the marketplace, as developments in telecommunications technology make certain geographic and product restrictions virtually obsolete."

He said too that the changes which have occurred in the marketplace could not have been anticipated by the laws and regulations now on the books. He further said that the blurring of distinctions among financial institutions raises questions about the separation of markets under applicable laws and the notion of applying sharply different regulatory approaches to institutions with different labels performing many of the same functions.

Also calling for an examination of Glass-Steagall are two other prominent government officials — John S. R. Shad, Chairman of the SEC, and Anthony N. Solomon, President of the New York Federal Reserve Bank. In testimony before the Senate Banking Securities Subcommittee, Chairman Shad recently called for the creation of a task force to consider regulating financial services and products along functional lines, rather than industry classification. According to the SEC Chairman, the task force would have a "one-year mandate to develop a framework for legislation to update, simplify and rationalize the system." Specific issues suggested for study by Mr. Solomon in a May, 1981, address before a meeting of the Investment Association of New York included the following:

- *the potential for conflict of interest, abuse and unfair tie-ins;*
- *concentration of economic and financial power;*

- *public support mechanisms to avoid significant risks to financial market stability;*

- *appropriate anti-trust standards;*

- *geographic restrictions included in both state and federal banking laws;*

- *economic costs and benefits involved in any proposed change;*

- *separate supervision, i.e., the need to develop methods of detecting conflicts of interest and other imprudent practices resulting from a relaxation of Glass-Steagall; and,*

- *devising and applying level playing field concepts of supervision to bank and non-bank participation in the financial services sector.*

Recent actions by the regulatory agencies also reflect a change in government attitude and, to some degree, the Administration's call for deregulation. In that connection, it would appear that the bank regulators have been following what perhaps can best be described as liberal policies in response to their constituents' desire to engage in securities activities. For example, in addressing the applicability of the Glass-Steagall Act to the securities activities of insured nonmember banks (of which there are more than 9,000), the FDIC issued a policy statement on September 1, 1982, which said that the Act "... does not, by its terms, prohibit an insured nonmember bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities."

The Comptroller of the Currency also took action in this general area recently when it approved Security Pacific's petition to operate a securities subsidiary. The Federal Reserve Board is currently wrestling with BankAmerica's application to acquire Charles Schwab & Co. Notwithstanding the legal challenges to certain of these actions, it would appear that, at least up until this point, bank regulators have not taken an adversarial position in response to their charges' proposed incursions into the securities industry.

As a federal agency, the SEC has not been immune from the deregulatory initiatives building throughout government. As Chairman Shad said in testimony before Congress regarding S.1720, "[T]he SEC is not only a proponent, but a practitioner of deregulation. For the last several years, the Commission has been engaged in a major effort to foster competition and to reduce regulatory burdens imposed on business by statutes which it administers." Numerous examples of recent SEC actions to faciliate capital formation by a more simplified scheme of regulation and by removal of artificial barriers and impediments to competition are becoming extensive. Some of the more significant of these actions include the Commission's adoption of Rule 19c-3, which eliminates off-board trading restrictions on newly listed stocks; its efforts to reduce the amount of disclosure required for seasoned, publicly traded companies as well as related actions applicable to investment companies and venture capital and other small issuers; and, its recent series of amendments to the net capital rule to which the broker-dealer community is subject.

The long-held views of legislators and regulators with respect to how and the extent to which these once separate industries should be governed is quickly changing. In some measure, acceptance of the notion that the regulatory framework governing all of this will change has promoted and perhaps accelerated the actual flow of change. With the more critical focus of the thrift industry soon to be out of the way, it would appear that 1983 will set the stage for our nation's legislators to attempt to shape the legal backdrop for the financial services industry of tomorrow.

Inflation/Interest Rates

For the past several years, double-digit inflation and record high interest rates, which have only recently begun to ease, have impacted the nation's economy from all directions. These very powerful forces affect people in all walks of life, virtually every type of business enterprise and all levels of government. High interest rates and, in particular, real interest rates (market rates less the inflation rate), have worked in tandem to stall the economy. For example, in August, 1982, U.S. factories and mines were operating at 68.9% of capacity, down sharply from a 1979 average of 85.7%. Bankruptcies are now nearing post-World War II highs and, before the year is out, may total more than at any other time since 1932. Unemployment, at a post-depression period high of slightly more than 10%, is a growing national concern.

Inflation which has been accelerating for the better part of two decades has fallen off sharply and is now running at an annual rate of somewhere between 5% and 6%. The prime rate, currently hovering around 12%, was in excess of 20% slightly more than one year ago. GNP, the total output of the nation's goods and services, will probably show little, if any, real growth for the current year.

As these data suggest, our nation's economy has been on a roller coaster ride for the better part of the last ten years. Its effects have not left the consumer of financial services untouched. Generally speaking, he has become much more sophisticated by becoming more inflation conscious and risk sensitive. In so doing, he has changed a fair amount of his investing and savings habits. One of the most visible indications of his changing habits is the wholesale withdrawal of funds from passbook savings accounts and subsequent deposit into money market funds. As noted earlier, since introduced in 1974, money market funds have grown from $1.7 billion in assets to more than $200 billion by mid-year 1982.

Up until the last few weeks of August, the forces of inflation and high interest rates also forced many investors out of traditional investment products, namely, stocks and long-term bonds. High inflation rates also present the consumer with a strong disincentive to save. Whenever the rate of inflation approaches and/or outstrips an investor's rate of return on savings, his motivation is to spend and not to save or invest. In seeking other alternatives, more sophisticated, wealthier individuals have been quick to invest their funds in high return, tax free bonds as well as a wide variety of products having flow-through tax benefits.

Recognizing the impact of inflation on the consumer of financial services and in response to his needs for preservation of capital and market rates of return, the providers of financial services have produced a vast array of imaginative and creative products.

The Role Of Technology — The Needs That It Fills

The computer and various advances in the field of technology must not be overlooked in any discussion of "why" our industry is in the midst of rapid change. While many revolutionary developments have occurred in the technology-based support services of the industry, it is probably fair to say that this is simply the beginning. However, to say that technological developments are occurring rapidly is perhaps an understatement.

Technology responds to industry's needs by providing it with expanded capacity, the ability to acquire a competitive edge and, in view of the pressure on profit margins, the opportunity to control selling costs. One of the principal areas in which we see the benefits of technology in our business is in transaction processing. We shudder at the thought of what 140+ million share days on the NYSE and 50+ million share days on NASDAQ would have meant only a few short years ago. Clearly, technology has become the critical binding to the fabric of our industry by providing it with the transaction capacity to handle high levels of unprecedented volume. It is essential to the future viability of our industry that it continue to have the capacity to process and complete business as it is "written."

Technology also fills another basic need of industry — the need to be competitive. In this highly entrepreneurial business, each of us seeks out ways to acquire a competitive edge. One of the principal routes we follow to get a leg up on the competition is to provide products and services our counterparts do not. These extras, we figure, will help us attract the clients of others and, at the same time, protect us from losing the ones we have. Many of the products and services we now offer clients are deeply rooted in and made possible through the benefits of technology.

Finally, we use technology as a vehicle for controlling and, in many cases, reducing our selling costs so as to create greater efficiency of operation. More efficient transaction delivery and information systems work to lower costs and hopefully increase profits. For those who do not get a handle on these costs, their fate is predestined. For those who do, assuming the critical mass needed to support these systems is generated, their chances of success are much brighter.

III. What Is The Outlook For The Future?

Introduction

In the first two chapters of this report, we examined what is going on in our industry today, together with some of the "whys" behind it. In this last section, we take a look at the effects of this change on the consumer and on the providers of financial services and their sales staffs. Many of these views of the future are not new or novel nor are they based on massive quantities of empirical data. They are, however, reflective of the thoughts, judgments and perceptions of people in our business who met with our Committee and who are capable of influencing the industry's future direction.

Surely the industry of tomorrow will be reflective of the ongoing process of change. The numerous forces at work in the marketplace shaping this change will, in turn, interact with one another to spawn still more change. In the world of tomorrow, a single technological breakthrough or a single government action may cause ripples throughout the industry. Everything touched by this innovation or action by government will itself change to some degree. Examples of this phenomenon are endless. It is probably safe to say too that the number of technological innovations and government actions that will impact upon the financial services industry of tomorrow will be extensive. Other environmental factors affecting the industry such as economic conditions and consumer needs are also unlikely to remain static — change in these areas is likewise inevitable. The point of all of this is that change will be a way of life for our industry and the leading indicators would seem to suggest that an accelerating pace is likely.

Tomorrow's Consumer Of Financial Services

As noted earlier, much of what is going on in the industry today is in direct response to changing investor needs. In talking about the factors influencing financial services strategies, Harry L. Freeman, Senior Vice President of American Express, observed that "the future (shape of the marketplace) is very much in the hands of a new breed of consumer. That consumer today is as different from yesterday's as the computer differs from the slide rule. And this trend is irreversible. These consumers are more affluent, more sophisticated, more interest rate sensitive, more inflation and risk sensitive. They are the product of materially changing demographics and probably are less loyal to institutions than in the past."

Many agree with Mr. Freeman. In support of this proposition, we have seen the spectacular growth of money market funds and, as Merrill Lynch points out in its latest Annual Report, the advent of the Cash Management Account, shaped in large part by in-depth research studies of customer needs. These developments clearly suggest that there is a growing customer awareness of what is going on in the marketplace. No longer will the consumer maintain his savings in a passbook account paying 5% when market rates of return are available.

The growing sophistication of consumers will undoubtedly continue. Volatile economic conditions, which are likely to persist well into the decade ahead, are generating financial services needs for consumers in virtually all areas — from asset management and insurance to tax guidance and estate planning.

The consumer of tomorrow will not only be more knowledgeable about the products that he buys but he will also be extremely price conscious. This may mean that waning loyalty to a single institution could diminish further as the consumer seeks out products and services best suited to his needs at attractive prices. Further, with the prospect of instantaneous access to markets and products, the customer of tomorrow may become more of a comparative shopper. This does not necessarily mean that tomorrow's consumer of financial services will always be seeking out the lowest possible price. If he knows what he wants and is not interested in personalized service, he may go the "no frills" route. If, however, he is looking for individualized attention and professional help in the form of customized services, he will pay the price. In sum, tomorrow's consumer will be more discriminating in terms of with whom he deals and at what price.

The marketplace of the future will also have a profound effect on the consumer both in terms of the sheer number of products and services available and the nature of the firms offering them to him.

As discussed in the prior chapter, there has been a new products explosion in our industry the likes of which have never before been seen. In addition to old line staples, such as stocks and bonds, there are now options and futures on virtually every securities and commodities product imaginable; in addition to the traditional stock and bond mutual funds, there are now fund products of every type — commodity funds, tax exempt long-term funds, tax exempt short-term funds, international funds, options funds and so on; there are now, too, countless numbers of newly designed insurance and annuity products; also available are an almost unlimited array of tax sheltered investments; growing in number too is a plethora of financial instruments being issued by public and private interests — on and on the list goes. Other products and services have also made their way into the marketplace linking two or more products or services together. The best example of this is clearly the asset management account which, as noted, combines the securities account with automatic investment of credit balances in money funds at market rates and charge card and checkwriting privileges. An increasing number of interesting and novel features have been added to the expanding list of second generation asset management accounts now making their way to market.

The creative process which launched this new products explosion can be expected to continue as better ways are found to respond to investors' changing needs, as the competition heats up among a growing number of competitors, and as we learn to apply state of the art technology in new and different ways.

As the nature of products available in the marketplace has changed, so have the providers of those products. Much has already been said in this report as to how the providers of financial services have already changed and a discussion of how they may change in the future appears later in this report. There are, however, several observations about tomorrow's providers of financial services that should be discussed in the context of how they will affect the consumer of the future.

The first of these is simply that as the number of entities bidding for control over the savings and investments of the consumer grow, the consumer will receive improved service and be able to select from a wider variety of investment alternatives. Unencumbered, healthy competition normally works in the marketplace to lower prices. Lower prices, in turn, normally result in increased purchases of goods and services by the consumer. Whether this classic economic theorem will prove true in our industry remains to be seen but the prospect of such should not be ignored.

The second observation to be made is that the consumer of financial services will have many active participants in the industry from which to choose to direct his business. In that connection, many believe that the providers of tomorrow's financial services will come in all shapes and sizes with the large financial conglomerates co-existing and competing side-by-side with smaller independent firms.

As a final observation about the impact of industry change on the consumer of tomorrow, it should be mentioned that many participants in the financial services industry are aggressively seeking to establish multiple relationships with both customers and prospective customers. The purpose of this action is twofold. The first is to overcome the problem of customer loyalty to a given institution. That is, if a number of a customer's financial relationships are consolidated under one roof and intertwined within a single firm or family of firms, the shifting of that account or any of the services associated with that account becomes less and less likely. The complexity associated with making any such move would appear to support that proposition. The second purpose of a multiple client relationship is to attract customers and potential customers to the firm at an earlier age. For the typical securities firm, its typical new customer is someone who is in his forties and, with child-rearing years behind him, has begun to develop a nest egg which he seeks to invest.

What many of the giants are doing is seeking to attract a client at a much earlier stage in his life, even before he has investable funds at his disposal, in order to develop an ongoing relationship with a potential securities customer. Merrill Lynch, for one, is pursuing this today through real estate brokerage and real estate financing. As Merrill sees it, if the lender which gave you your first mortgage when you were in your 20s or 30s provided a full range of financial services, it is more than likely that you would have a number of financial relationships with that institution today, including perhaps a securities account.

In the battle for multiple client relationships, Shearson/American Express has taken a more obvious route. There are many young American Express cardholders who have not as yet accumulated significant amounts of investable assets. The Shearson approach is to nurture these cardholders so as to provide the "greenhouse" they will need in order to develop into full fledged securities investors. The so-called nurturing process is to include use of the low minimum Financial Management Account (Shearson's version of the asset management account) coupled with the American Express Gold Card.

Asset management accounts are also gaining in popularity mainly for the same reason — when opened, they automatically create multiple client relationships. What many perceive as a single product is, in fact, a multi-product. As additional features are added to this increasingly popular product, the client will become more closely tied to its providers.

The purchase of broker-dealers by insurance companies is another indication of the routes others are taking to arrive at the same destination — multiple client relationships. The cross-selling of products between insurance companies and acquired broker-dealers may in time produce a synergism that will strengthen the ties of a firm to its customers.

In sum, tomorrow's consumer of financial services will be more knowledgeable about the marketplace, more informed as to his own needs and served better through both increased competition among the providers of financial services and a growing number of products. He will be served by both large and small providers of financial services — the specialist and the generalist. Also, through various means, many financial institutions will seek to develop a relationship with a customer even before he has amassed funds for investment.

The Future Providers Of Financial Services

The structure and composition of the financial services industry of tomorrow will, in large measure, be influenced by the federal government and the states — on both the legislative front and the administrative level. At this time, it would appear fairly certain that a comprehensive congressional airing of fundamental Glass-Steagall issues will begin sometime in 1983. With the prospect of congressional inquiry on the horizon, many of the administrative agencies may be inclined to move slowly on the Glass-Steagall issues currently pending before them.

Notwithstanding the fact that Congress is the ultimate arbiter of who will be able to do what, there are many, many things that have been put into motion from which there can be no turning back. Images of what used to be can no longer be confused with what is.

In the words of Walter Wriston, "... the financial marketplace today is everywhere, any time. The parties to the transactions could be anyone with the ability to punch in the right numbers anywhere. Financial transactions are now being performed in living rooms via cable TV or through a terminal in a corporate treasurer's office. What will be the value of a seat on the New York Stock Exchange or a brick-and-mortar bank branch in an environment where every home has access to the Dow Jones and its bank accounts instantaneously? In this kind of world, electronics have become money, credit, securities or savings, and are more real than places."

Increased Emphasis On Technology

Communications and technology have revolutionized the financial services industry and are likely to continue doing so. On the plus side, technology is reducing our transaction processing costs and it is speeding the flow of information to investors. It is conquering the limits of space and time. It has also facilitated the increase of new products and innovative services into the marketplace. It is working to make salesmen more productive and for those with systems ideally suited to their needs, it has given them an edge in competing for business. On the negative side, it has raised the price tag for those seeking to become full-range competitors in tomorrow's marketplace. Computer facilities carry with them tremendous initial costs with tremendous ongoing obligations.

With certain exceptions, the spiraling costs of sophisticated electronic data processing and information systems may serve as an entry barrier to all but the largest of financial institutions. The principal exception has to do with the fact that different models exist for different firms. No two are alike in terms of business activities or methods of operation. The systems that may be right for one firm may be totally wrong for another. There are so many variable factors to consider such as single versus multiple locations, client base, product mix and so on, that it is virtually impossible to make blanket statements about the extent of systems needs of different firms — requirements in this area are very individualized things. Most do recognize, however, that costly telecommunications and information systems are going to become increasingly important to the firms of the future since the securities industry is essentially in a communications business.

In order to survive in the future, many believe that, at a minimum, a firm will have to provide its customers with a basic core of technology-based services. The ability to provide market information and current account data have been identified by most as high priorities for the firms of tomorrow. Market information, being readily available from a variety of vendors, should not be a particularly serious problem for a firm to overcome since it would not have to generate or create this information itself. However, information regarding the current status of a client's account, especially in the form of on-line data, will be essential to both retaining the client and recruiting sales personnel.

With evolving technologies, a variety of relatively inexpensive systems are making their way into the marketplace and it is expected that they will do much to relieve some of the cost pressures. The advent of the microprocessor provides convincing evidence of how technology can bring down costs. It was not too many years ago that a limited function calculator was a bulky item costing upwards of a thousand dollars. Today, they can be as small as a business card and cost but a few dollars.

Since nature abhors a vacuum, it is anticipated too that some of the wholesalers of clearing and related services in our business as well as others in the telecommunications field will step forward and render on-line data services to smaller firms that do not have an in-house capability. Regardless of whether the firm of tomorrow develops in-house systems, or buys, rents or leases them, it will have to find some way to afford the technology it will need to succeed. As noted earlier, technology needs are and will continue to be very individualized things.

The fact that there will be an increased dependence on technology by the financial services firm is not an issue in debate. There is, however, one very important question and that is — how much technology is enough? Our first reaction to new technology is to use it in every way imaginable. A firm can quickly get caught up in the desire to provide ultra-sophisticated systems and marvelous forms of electronic gadgetry to its various operating departments and its clients. It must resist that temptation or it will run the risk of rapidly diminishing returns. While there is no pat answer to the overriding question "how much is enough," there are a number of sub-questions to consider which may help key the answer. They are:

- *Is this a critical service which I must provide — or capability I must have — in order to retain and/or attract clients?*

- *What will be the cost/benefit of introducing a new technology-based innovation?*

- *Will the critical mass be generated to support it?*

The answers to these questions should help tell a firm "how much is enough."

As noted earlier, computer facilities as well as information systems of virtually every type involve considerable ongoing costs. Because of this, it will be extremely important for firms to get control over those expenses. James L. Bayless of Rauscher Pierce said that any firm that does not have control over its systems costs will have serious trouble within the next three to five years.* On this point, it is worth mentioning that the Rauscher Pierce/IFG decision to merge was due, at least in part, to the fact that both Rauscher and Dain Bosworth, IFG's other securities subsidiary, were at the so-called cutting edge of the critical mass required to support the automated systems needs of both firms and this break-even point was only comfortably exceeded when the merger took place and the necessary volume was thereby generated.

According to Mr. Bayless, it is far more desirable for a firm to provide for its own systems' needs rather than depend on an outsider. Although normally a less expensive alternative, he pointed out that service bureaus often find it difficult, if not impossible, to tailor their systems to fit a given firm's needs since other firms are on the same system. What's good for one must be good for all.

The growing dependence of our industry on technology will require a reorientation for many of us — both the providers and the consumers of financial services. Unaccustomed to using electronic devices and systems, many of us are going to have to re-educate ourselves so that we more comfortably fit the world in which we live. We will have to develop new skills in order to make optimal use of these new and emerging facilities.

Down the road, many see the consumer of financial services handling the bulk of his financial affairs directly from his home, through a personal computer/video hook-up to the providers of financial services. Although some question whether the public will accept this mode of transacting business, one industry observer said that the maturation and economic flowering of the "Pac-Man" generation will assure its acceptance then if not accepted beforehand. In a novel series of experiments in electronic marketing begun last year, both Sears, Roebuck and American Express have been pioneering two-way communications with consumers via home video, telephone and personal computers. Sears, for example, did the following: put its summer catalog on videodisc; by means of touch sensitive televisions in the home, provided selected customers with the ability to place orders; and, through personal computer hook-ups, allowed users to access merchandise descriptions and place orders directly through a computer interface. A growing number of people in both the securities and banking industry see the home video link as the next major step in the evolution of the financial services industry. However, a few skeptics point to the fact that the automatic teller machines that banks have been installing for nearly a decade have not been successful in reducing by even one the number of costly branch offices. All ATM's have done, they say, is simply increase the overhead since the banks are now running parallel systems neither of which is likely to replace the other any time soon. The unanswered question to all of this is how many branches have not been necessary and thus not opened since the advent of the ATM.

---

*James Bayless, President of Rausher Pierce Refsnes, Inc. died on October 12, 1982. Mr. Bayless' thoughtful comments and candid remarks were very helpful to the Committee in pursuing its tasks.

Industry Composition And Structure

The financial services industry of today is far different than it was when the regulatory structure governing its many components was created. While the industry itself has undergone rapid evolutionary development, as noted elsewhere in this report, its legal framework has not. Because of this, there is much conversation today about reshaping our laws and the regulations that accompany them to provide the so-called "level playing field" upon which all providers of financial services can compete equally.

Exactly how this will be done has not yet been determined; but, when it is, one thing is likely — many of the regulatory barriers to competition will disappear. This means that formidable competition in a variety of areas, long the province of the securities industry, will emerge from banks, insurance companies and financial intermediaries of many kinds. The other side of the coin is that this removal of regulatory barriers will also work to produce new opportunities for those inclined to seize them. New profit opportunities will be a direct result of new product development, improved quality of service, access to new markets and diversification into other financial as well as non-financial businesses. In addition to the typical providers of financial services, others, including vendors and suppliers of telecommunications and information systems, will also experience new opportunities — so much so that technology-based services may be one of the most rapidly expanding fields in the 1980s.

In the competition heating up for consumers of financial services, many believe that the securities industry is better positioned to compete in the world of tomorrow since it already operates in a telephone-based, electronic environment, in sharp contrast to the slower paced face-to-face deposit or insurance business. Many feel that it is easier to build for an upscale market through a business customarily transacted over the phone than one which operates mainly on the basis of personal contact. Hence, the transition to the environment of the future may very well be less difficult for today's securities industry participants.

In the opinion of many, the financial services industry of tomorrow will include firms of many types and sizes. With the crumbling of regulatory barriers to competition, it is anticipated that on the national scale, the number of full range competitors is likely to increase. This will probably be followed by a period of contraction and consolidation as firms which were tempted by the removal of confining elements wind up in businesses in which they have little if any knowledge or practical experience and in which they have invested huge sums on technology.

Most agree that the financial supermarket will co-exist and operate side-by-side with smaller firms which are able to identify specific needs of consumers and thereafter move quickly to fulfill them. The bottom line is simply this — if a firm performs a legitimate economic function, and it performs it well, its chances of survival are greatly enhanced.

In the years ahead, it will probably become increasingly difficult for the smaller firm to build a fully integrated, full service, full product line business. Simply stated, to gear-up for the future will become more difficult mainly because most of the forces existing in the environment, such as escalating costs and more intensive competition, are not going to go away, but rather, are likely to intensify. Because of this, many of the smaller firms of tomorrow are likely to specialize by finding niches for themselves so as to compete on the basis of quality of service.

In order to survive in this changing environment, the broker-dealer community will have to be more concerned with and more conscious of the need to compete. Merrill Lynch's Robert Rittereiser likened the situation today and the anticipated entry of new competitors into the marketplace to the period immediately preceding the removal of fixed rates. He cautioned that the lessons of 1975 should not be ignored by those looking to the future. His point was that those who hid behind barriers had serious adjustment problems once those barriers were removed. In recalling the experiences of our own industry, he observed that fixed commissions were so ingrained in our thinking that many of us did not know how to compete with one another when the opportunity to do so finally arrived. Even today, he said, the absence of a competitive environment in many sectors of our business may have given a number of people a false sense of security. By holding onto outdated concepts, he continued, they may very well find themselves ill-prepared to deal with the competition that banks and others on the periphery of our business will soon present.

Most participants in protected industries have probably never needed the rules they have operated under in order to survive.

According to Mr. Rittereiser, if a firm has been good at what it does, it will make money; if it is not, it will fail. As we move to a changing environment, he implored firms not to lose confidence in what got them to where they are in the first place. *The key to survival in the world of the future*, said Mr. Rittereiser, is directly tied to a firm's quality of planning, adaptability to change, and an honest appraisal of its strengths and weaknesses.

Many knowledgeable people expect that competition for financial services customers will take on new dimensions as the number of competitors grows. One of the most lucid descriptions of the scope of future competition was given to the Committee by Garnett L. Keith, who said, in tomorrow's environment, competition for the financial services customer will revolve around the following key items:

- *competition for investor confidence via the providing of products and services of high quality;*
- *competition on the basis of efficiency in terms of pricing of products and services and the convenience by which they can be delivered to the customer;*
- *competition through innovative use of technology; and,*
- *competition via the rendering of personal services.*

In the context of growing competition, one of the more interesting developments to have occurred in recent years is the fact that, in certain areas, the customer has gained the power both to compete directly with the providers of financial services and to dictate the price they may charge for them. The former is best illustrated by the recently acquired option now available to issuers permitting them to sell registered offerings of securities directly to institutions by means of SEC Rule 415. The institution, normally the customer of the broker-dealer, can now compete on an equal footing with the broker-dealer in bidding for new offerings of securities. The latter is best evidenced by the pressure exerted by institutions in lowering per trade costs. The crumbling of regulatory barriers, the growing institutionalization of markets, advances in communications technology and other factors have collectively contributed to elevating the role and influence of the customer in the marketplace. In addition, the ability of customers to by-pass the broker-dealer and his power to influence price reflects a further erosion of some of the more traditional forms of business upon which the securities industry has relied. As a consequence, it gives rise to some significant long-term implications.

Rule 415 in particular is having a tremendous impact on the nation's capital-raising mechanism. When the rule was in the development stage, many industry spokesmen observed that the rule would do a number of things. They said as follows:

- *it was likely to eliminate regional firms and smaller broker-dealers from their historical role in the distribution of nationally syndicated offerings;*

- *it was likely to accelerate the institutionalization of the nation's securities markets;*

- *it was likely to benefit the organizations with exceptionally large retail distribution systems; and,*

- *it was likely to increase underwriter risk substantially by reducing the number of participating dealers due to an unwillingness or inability to bear added risk independently or with others in smaller syndicates.*

With the experience gained to date, it would appear that three of the four concerns identified above have indeed materialized. What has not happened and what may not ever happen to any large degree concerns the prospect of firms with large retail distribution systems doing Rule 415 deals. In discussions at the recently concluded "SEC Conference on Major Issues Confronting the Nation's Financial Institutions and Markets in the 1980's," Robert H.B. Baldwin, President of Morgan Stanley & Co. Incorporated, observed that Rule 415 has not worked to the benefit of the large retail house. He said that "as it turned out, the spreads were so narrow, the turnaround time so short, that it [issues offered via Rule 415] ended in concentrating on the institutional market because there was no spread there to allow the salesman the ability to work."

Clearly, the jury on Rule 415 is still out. Whether the transaction-by-transaction competition fostered by Rule 415 will in time be outweighed by the consequences the rule produces is an extremely difficult question to answer and one which is beyond the scope of this report. It suffices to say, however, that the underwriting business, like so many other facets of our business, is rapidly changing.

With new competitors lurking over the horizon, with increased use of technology an every day event, and with economic conditions so uncertain that every forecast is replete with endless caveats, it is a given that the environment will continue to change. This element of change makes it harder to be a competitor since it adds another dimension to the challenge of knowing how to compete. As Mr. Rittereiser also explained, to succeed in the future, a firm must be responsive to the changing environment and develop a marketing approach to promote the things it chooses to do. In this changing environment, he said a firm must:

- *know its customers and the market it serves;*

- *know its products;*

- *know how to price;*
- *know how to maximize opportunities; and,*
- *know how to minimize threats to its business.*

The desire to be competitive in tomorrow's environment has already caused a number of firms to position themselves for the future. Acquisitions by securities firms and acquisitions of securities firms by both financial and non-financial institutions underscore the dynamic forces at work in our industry. Many of those with whom the Committee spoke seemed to think that the major merger activities of the large players have already taken place although a few more may occur over the next five years. According to Andrew J. Melton, Jr., of Dean Witter/Sears, the financial services industry of tomorrow — from the securities side — is starting to take its final shape. The last act will be played, he said, when Congress makes a final determination concerning Glass-Steagall. He believes, however, that the commercial banking business is likely to undergo considerable change mainly in the form of contraction and consolidation. He points to the fact that in the United States today, there are over 15,000 commercial banks while in the United Kingdom there are but ten.

It should be noted that there are a number of people who view the projections of many of the principals involved in the formation of the newly created financial conglomerates as being overly optimistic. Although times have in fact changed, they point to past mergers and the failure of the anticipated synergies to develop between companies as a basis for their views. They suggest too that it is unlikely that the upscale customer will want to have all of his financial affairs handled in a supermarket environment.

A lot of very bright people believe, however, that there is a place in the market for one-stop consolidated shopping. They point to a recent SRI International study which says that the typical affluent American household deals with about 20 different financial vendors and buys approximately 40 different types of financial services including insurance, securities, financial advice, real estate, banking services and so on. Believing that the consumer will want to consolidate at least some of these arrangements, the financial conglomerate, with the prospect of economies of scale, appears to have been a very logical outgrowth in the industry's evolutionary development. These firms seem to have realized, however, that notwithstanding the obvious benefits large financial conglomerates can produce, their success or failure will ultimately depend on their ability to render personalized service. They know full well that of the four services a securities firm typically renders — the execution of transactions, the providing of information, the giving of advice and guidance and the financing of transactions — three of them, if unbundled, could be purchased elsewhere at cheaper prices. These three services are, of course, used by the full service firm to support the fourth — the giving of advice and guidance. Since giving advice will become an even more critical service in the world of tomorrow, the full service firm, through its registered representatives, will have to become better at it in order for it to secure its future.

In terms of future industry composition, many see a legitimate marketplace need for the boutique. As noted in a recent study by the Hudson Institute, entitled *The Future of the Financial Services Industry,* "Boutiques could well thrive at the same time as financial supermarkets expand, rather than growing at a later stage as in other service industries which first experience new economies of size and conglomeration." Virtually all with whom the Committee spoke echoed this same sentiment.

Whether large or small, the financial services firm of tomorrow will endeavor to gain control over a client's assets. Many feel that the major key to a firm's success will be how well it does in this department. Many believe that the asset management account as well as an expanded range of financial services will be of growing importance in the decade ahead. They maintain that if, in addition to providing routine securities transaction services, a firm is able to arrange a line of credit for the customer, provide him with a credit/debit card, give him checkwriting privileges against his balances, pay him market interest rates on his funds awaiting investment, provide him with basic insurance coverages and, among other things, provide a tie-in to home equity, it will become unnecessary for the customer to deal with anyone other than the firm providing these services in order for him to satisfy his financial needs. So many aspects of the customer's daily financial life would revolve around that firm that his securities account would become virtually immovable. To transfer the account and re-establish all of the above-described relationships with another firm would be tremendously burdensome.

Although the smaller firm is unlikely to have the resources available to it to market a full line of packaged products and services, indications are that they may be obtainable on a wholesale or syndicated basis through some of the larger firms. Through some form of joint venture or through the wholesaling of nationally known products by nationally known firms, product gaps are likely to be filled for even the smallest of firms. That is, some of the large firms may soon offer their uniquely designed products bearing their name to others for sale through the purchasers' distribution systems.

While the current moves to acquire larger securities firms may have abated, as Mr. Melton suggests, most agree that current efforts to diversify into both financial and non-financial areas will continue. The decision by securities firms to diversify into both financial and non-financial businesses has generally been made for the following reasons:

- *to take advantage of opportunities whenever and wherever they occur;*

- *to offset the cyclical nature of securities market activities;*

- *to take advantage of the synergistic benefit that results from being able to extend the range of products and services available under one roof and to provide a base from which a full range of financial services can be offered;*

- *to establish a geographical presence in and penetration of markets otherwise inaccessible; and,*

- *to achieve operating efficiencies, e.g., through a securities firm's purchase of a service bureau.*

The principal areas in which securities firms have been diversifying include real estate (financing and brokerage), insurance, leasing, travel and relocation services, recordkeeping and computer services, and savings (via the formation/acquisition of thrifts), among others. From all indications, this trend will continue well into the future. Also, other forms of diversification, such as product line diversification, can be expected to pick up momentum as firms aggressively compete in the marketplace for clients.

Most of the people with whom the Committee spoke also said that, over the next several years, there would probably be a lot of sorting out of many facets of our business. These different facets include the composition and structure of the industry, the regulatory structure which will govern the financial services industry, the types of products marketed and so on. As to products, each of these people also said that his firm has a number of ideas with which it will be experimenting until it finds the things which work and those that do not. As a group, they generally agreed that what will separate the successful firm from the firm on the road to disaster will be the ability of its management to recognize unsuccessful ventures and mistakes and to be able to pull back from them quickly.

The prospects of the survival of the smaller regional firm in the world of tomorrow has been a matter of growing concern to many. The reasons cited earlier in this report — the price suitors are willing to pay, the escalating costs of technology and telecommunications, the need to have access to a wide variety of packaged products, the age and liquidity problems of senior management and changes in distribution methods via Rule 415 — have conspired to produce an alarming reduction in the number of independent regional firms. So far, the typical regional firm suitor is either a large nationwide insurance company or a large New York wirehouse.

The price being paid has been the largest single attraction for the regional firm. On average, the price paid has been somewhere in the vicinity of three times book value. For the senior managements of the acquired firms, the opportunity to sell at top dollar prices has been extremely difficult to pass up, particularly for those approaching retirement with few alternatives available for liquifying their investments. In many respects too, these regional firms have gone the merger route so as to be able to operate in the world of tomorrow. They have seen things on the horizon and they have been troubled by them — the high costs associated with computer facilities and advertising, Rule 415 freezing them out of the larger distributions, and their inability to produce packaged products, like the asset management account, which has great appeal to the upscale customer.

For the acquiring firm, the regional firm presents an opportunity to improve the bottom line by tapping new markets and by filling gaps in geographic coverage. Recent takeovers of broker-dealers by insurance companies appear to have been motivated by the desire to diversify the insurer's interests, to establish a presence in the upscale client market and to produce opportunities for cross-selling products.

Although the number of independent regional firms that have been acquired in the past year number only a dozen or so, it represents a continuation of a process started some time ago. During the years 1970 to 1978, the securities industry went through a period of major contraction. NASD membership went from 4,470 to about 2,800 firms. Many of the firms that left the industry at that time — through either merger, consolidation or liquidation — were general securities firms with a regional orientation. Many of these were active participants in the capital formation process.

In a Special Report to the Senate Select Committee on Small Business, the NASD in 1979 wrote:

> *Many of the broker-dealers that have disappeared through mergers or termination are the smaller, local securities firms that provided a full range of services to local investors and local companies. It was these local/regional broker-dealers that brought many local businesses public and provided secondary markets for their securities.*

Recent events will serve at least in the short-run to exacerbate this problem. Takeovers of independent regional firms by New York houses as well as the non-participation of such firms in their traditional distribution roles as a result of Rule 415 may suggest even more difficult times ahead for local, developing companies seeking equity financing.

However, what appears to be the direction in which the industry is headed may never come to pass. The Committee has been told that a significant number of regional firms will jealously guard their independence and shun all merger advances. Managements of these firms like what they are doing and are not taken with the idea of doing it for someone else. There is also a growing feeling that the multiples of book value that have been paid for regional firms are now thought by many to have been on the high side and as such will no longer serve as the standard for future takeovers.

Some feel too that while Rule 415 has encouraged the absorption of regional firms by national firms, it has also produced a vacuum which will need to be filled. Firms which position themselves to be adaptable to change and build on their strengths should see this vacuum as a new opportunity to be exploited. Furthermore, very few argue with the notion that firms with a local identification, given adequate facilities and capabilities, have a tendency to attract larger accounts and more productive sales personnel. Also working to aid the smaller regional firm in its pursuit of a full line product base is the likely prospect that national firms may soon be offering their packaged products on a wholesale or syndicated basis to those who are interested. Similarly, high technology telecommunications and information systems are likely to become available and offered to regional firms and others by a growing number of competing vendors.

The prospects of smaller and regional firm survival in the emerging financial services world may not be as bleak as some would suggest. Indeed, most of those appearing before the Committee felt that all of the regional firms acquired in the recent wave of takeovers would not have been failure candidates, but rather, would have been highly successful competitors in the world of tomorrow had they retained their independence.

Tomorrow's Registered Representative

The registered representative of the future will change in a number of ways. First he will have to become better acclimated and more comfortable with using technology. He will have to get used to dealing with clients in new and different ways. At his fingertips will be an almost limitless amount of information about his customers — their securities holdings, cash balances, borrowings, insurance coverages — and an equally unlimited amount of information about the market and the products traded in it. In addition to knowing how to access this data, he will have to know how to sift through it to find that which will be of greatest value to his clients.

At his disposal too will be an ever-expanding product line. A comprehensive knowledge of the products available for sale and being able to compare one to the other in terms of the pluses and minuses of each will be essential in order for him to render high quality advice and guidance to the client.

Assisted by technology, the registered representative of tomorrow will undoubtedly become more productive. With more and better tools available to him, the registered representative's quality of service should rise appreciably and with that the income he generates both for himself and his firm. With firms seeking to establish multiple relationships with clients, it will be the registered representative who will command center stage and who, in large measure, will determine through his personal contact with the client whether the firm will succeed in this effort. In the quest for multiple relationships, it would appear that once in place, the customer's loyalty will probably shift from the registered representative to his employer for very practical reasons. When the registered representative of the future chooses for whatever reason to leave his employer, it is unlikely that his accounts will follow him mainly because the customer, if properly served, will not want to experience the hassle of attempting to unravel the many components of his financial relationship to the firm. Assuming this to be a correct assumption, it is reasonable to assume that tomorrow's registered representative, while becoming more productive, will become less mobile and more inclined to remain in one place.

IV. Summary Of Findings

The following is a capsule summary of the Committee's perceptions and expectations of probable industry developments in the decade that lies ahead. Many of the Committee's opinions were formed with the assistance of many helpful people who shared their valuable insights of the future with the Committee. Through in-depth conversations with these people, through a careful review of a significant number of studies, reports, testimony and media accounts of current developments, and through spirited discussion among the members of the Committee, the following have been identified as emerging consensuses as to where the financial services industry of the 1980s may be headed.

- *The evolutionary change going on in the financial services industry will not only continue at a rapid pace, but it is also quite likely to accelerate.*

- *Many of the regulatory barriers now separating tomorrow's competitors in the financial services industry are likely to be eliminated. Glass-Steagall can be expected to get a full airing in Congress in 1983.*

- *With the removal of regulatory barriers to competition will come increased business opportunities for those who are quick to recognize them and who know how to compete.*

- *As regulatory barriers begin to crumble, the proper management decisions will have to be made lest firms succumb to the temptation and rush into business activities for which they are ill-prepared and ill-suited.*

- *Until the regulatory barriers to competition disappear, there will be increased interaction and cooperative efforts between the banking industry and securities industry as each seeks to bridge the gaps that it has in the financial services currently provided. Until removed, existing laws and regulations will be pushed to the limit.*

- *The emerging financial services industry will become more competitive and consist of institutions of every type and size. The roots of these organizations will trace back to such diverse industries as securities, banking, insurance, real estate and telecommunications.*

- *The transition to the environment of the future may be less difficult for existing securities firms in that they already operate in a telephone-based, electronic environment as opposed to one which operates mainly on the basis of personal contact.*

- *Large multi-product firms or financial supermarkets which will service virtually every financial need of a customer will co-exist in* *tomorrow's world with smaller firms serving the unique needs of investors.*

- *By building on its strengths and emphasizing those things which it does well, the independent regional firm will not only survive in the financial services world of the future but it will also continue to attract quality personnel and substantial accounts.*

- *There will be a continuation of the current movement to diversify into both financial and non-financial areas, particularly by larger firms, as efforts are made to minimize the erratic behavior of traditional profit centers.*

- *Tomorrow's provider of financial services, regardless of size, will be required to have state-of-the-art technology and telecommunications facilities to retain and attract clients. The extent of these facilities will vary from firm to firm. Even the smallest of firms, however, will have to provide a basic core of technology-supported services. The need to control systems costs will be a paramount concern to all firms.*

- *Wholesalers of clearing and related services as well as firms in the telecommunications field will step forward to provide a full array of on-line data and market services to smaller firms lacking an in-house capability.*

- *Technology and instant communications will continue to accelerate transaction speed and the flow of information to investors thereby bridging territorial boundaries and creating world markets.*

- *Tomorrow's consumer of financial services will continue to be affected by volatile economic conditions and, as such, become more knowledgeable about his needs, have a better understanding of the operation of markets, be more sensitive to inflation and interest rate movements, and be more demanding in terms of prices he pays for the services he receives.*

- *Marketplace participants will take aggressive action to develop multiple relationships with clients to satisfy customer needs and to deal with the lack of consumer loyalty to a single institution. Also, firms will seek to attract clients at an earlier age, even before they have investable funds at their disposal, in order to develop ongoing relationships with potential securities customers.*

- *Before the decade is out, investors may be connected to the providers of financial services by means of personal computer linkages.*

- *Many new and innovative products and services will be offered in tomorrow's marketplace to fulfill the changing needs of a growing* *number of investors. The asset management account could be the most important single product innovation of the decade.*

- *Through joint ventures or as a result of the wholesaling of nationally known products by nationally known firms, product gaps are likely to be filled for even the smallest of firms.*

- *Greater emphasis will be placed on strategic planning by industry participants as they prepare for the challenges of tomorrow.*

- *The registered representative of tomorrow will make greater use of technology, sell a vast array of innovative products, become better at giving advice and, as a result, become increasingly more productive. However, due to the impact of multiple client relationships, he will not be as mobile as he is today as customer loyalty begins to shift more in the direction of the firm providing multiple financial services and away from the registered representative selling them.*